1985

Alternatives to the present tax system for increasing saving and investment

American Institute of Certified Public Accountants. Federal Taxation Division

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AICPA American Institute of Certified Public Accountants
1620 Eye Street, N.W., Washington, D.C. 20006-4063

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Foreword

The AICPA Tax Division's Task Force on Changing our Tax System to Encourage Savings and Investment Relative to Consumption was formed in 1981 in response to national concern over the low level of savings and capital reinvestment relative to other industralized nations. Since the tax force was formed, the U.S. has provided substantially increased capital-formation incentives; the nation continues to have a low rate of investment relative to consumption, however, and to suffer severe balance of payment deficits to other countries that are reinvesting more heavily. At the same time, the U.S. has been examining alternative tax systems designed to encourage simplicity, fairness, and capital formation. We believe that this study can contribute significantly to an understanding of the problem and to possible alternative approaches to encourage savings and investment relative to consumption.

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In addition, Sarah Bonner and Dwayne Horii, of the University of Michigan, served as graduate student assistants, developing drafts under the direction of the task force; William Stromsem of the AICPA provided staff support. The task force also wishes to thank the Value-Added Tax Task Force for its important contribution in that topic area.

The task force reports to the Tax Policy Subcommittee, and through it, to the Tax Division Executive Committee. Members of those committees when the report was approved were as follows.

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INTRODUCTION

In recent years, there has been widespread publicity concerning the decline in productivity, saving, and investment in the United States. Some of the media's attention has focused on the decline relative to other industrialized nations, while other coverage has emphasized the decline from past U.S. rates. Many economists, government officials, and others have expounded reasons for the declining rates, including the influence of government policies.

This report is premised on the assumption that increasing saving and investment is desirable. Within the range of government policies influencing productivity and saving, the tax system is pervasive. It has proven an efficient means of providing economic incentives and, hence, can be used either to encourage or discourage saving and investment. Thus, the report addresses those tax alternatives that encourage relatively more saving and relatively less consumption (in the business context, the parallel concept would be the encouragement of capital formation).

The American Institute of Certified Public Accountants is well-acquainted with tax laws; hence, the thrust of this study document is to analyze potential changes in those laws. However, tax laws are not the sole, or perhaps the best, vehicle for influencing saving and investment. Many economists advocate that a better method would be to reduce government deficits or expenditures or both, while others defend the use of monetary policy. Still others propose changing government regulations and moderating inflation. While all these views are worthy of discussion, the scope of this study document is limited to potential changes in tax laws.

The report examines potential changes to our tax system in three broad areas. First, it investigates a more comprehensive income base that would permit significantly lower rates. This area encompasses a number of current congressional bills as well as the November, 1984 Treasury Department simplification proposals. Next, the report examines the taxation of consumption rather than income (also the subject of several current proposals). Finally, it addresses changes that can be made to the current income tax system to encourage saving relative to consumption. Although each of the alternatives affects saving and capital formation in different ways, no policy stance or recommendation is made with respect to any of them. As a study document, this report is intended to inform AICPA members and others of issues and alternatives relating to the subjects within its scope, but it is not designed to set forth any policy position of the AICPA or its Federal Tax Division.

This study draws upon numerous sources for suggestions and analysis; two of the most important are *Blueprints for Basic Tax Reform,* the classic reference in the area of tax reform, which was published by the Department of the Treasury in 1977, and the *1984 Treasury Report on Tax Simplification and Reform.*[1] Both *Blueprints* and the Treasury proposals contain substantial contributions to knowledge on the subject of tax reform; they, as well as the other materials in the bibliography, should be studied carefully by the serious and interested reader.

It should be noted throughout that reference to the "Treasury proposals" is to those of November 1984. While the 1985 Administration proposals vary, this document has used April 30, 1985, as a cutoff point for any proposals. Consideration of later material would not add materially to knowledge of the issues involved and would delay release of the study unduly.

Chapter 1

STATEMENT OF THE PROBLEM

The claim that Americans save too little has become the topic of much debate in recent years. Those who make the claim cite two reasons for believing that the saving rate is too low. They compare the U.S. rate with those of other industrialized countries; usually, the U.S. rate is near the bottom of the lists. They also compare the U.S. rate with prior U.S. rates and report a declining trend. The tables below illustrate these claims.

Table 1

Net Household Saving as a Percentage of Disposable Household Income, 1960-1982

	U.S.	*Canada*	*United Kingdom*	*West Germany*	*Japan*
1960-67	8.0	5.7	5.6	16.4	17.0
1968-73	9.2	6.9	5.5	14.7	18.2
1974-79	8.8	10.6	8.1	13.3	21.4
1980	8.0	12.6	11.1	12.8	19.2
1981	8.5	14.1	8.7	13.6	19.7
1982	7.7	15.5	7.1	13.0	17.7

Source: Organization of Economic Cooperation and Development (OECD). Economic Outlook. *Historical Statistics 1960-1982.*

Table 2

U.S. Personal Saving (National Income Account Basis) as a Percentage of Disposable Personal Income, 1961-1984

1961-65	6.3
1966-70	7.3
1971-75	8.1
1976-80	6.1
1981	6.7
1982	6.2
1983	5.0
1984	6.1

Source: U.S. Department of Commerce, Bureau of Economic Analysis, *Survey of Current Business* (Washington, D.C.: USDC, 1985)

Opponents of this argument attack the definition of saving used in tables such as table 2. In general, saving refers to the flow of income and production into uses other than current consumption; however, the statistics used in these two tables do not measure all of the consumption deferred or capital accumulated. In the National Income Account (NIA) statistics, saving is a residual — equal to disposable income, less current personal outlays for goods, services (including the estimated value of housing services), interest, and transfers to foreigners. The NIA concept of personal saving does not include durable consumer goods, which permit consumption in the future, or the changes in market value of existing assets. Thus, the NIA statistics understate the amount of consumption deferred.

Another definition of savings that includes accumulation of durable goods is the flow-of-funds basis, used by the Federal Reserve. Flow-of-funds household saving is equal to the increase in household stocks of durable goods, nonfarm homes, and noncorporate assets, less depreciation of those assets, plus net investment in financial assets, less increases in household debt. Personal saving on a flow-of-funds basis equals flow-of-funds household saving, less government insurance and pension reserve, net investment in consumer durables, capital gains dividends from mutual funds, and net saving by farm corps. Using the flow-of-funds basis, the U.S. saving rate becomes nearly a quarter higher than the rate provided in NIA statistics (see table 3).

Table 3

Household Saving, Personal Saving, and Personal Saving as a Percentage of Disposable Personal Income (Flow-of-Funds Basis). 1960–1984 (In Billions of Dollars, Seasonally Adjusted Annual Rates)

	Household Saving	Personal Saving	Percentage of Disposable Income
1960	36.7	26.2	7.4
1965	65.0	39.1	8.2
1970	86.4	56.7	8.6
1975	153.0	111.1	10.1
1980	234.7	165.3	9.0
1981	273.9	192.0	9.4
1982	296.3	209.7	9.6
1983	300.3	175.8	7.5
1984	354.0	204.6	7.9

Source: Board of Governors of the Federal Reserve System, *Flow of Funds Summary Statistics* (Washington, D.C.: FRS, 1985)

The unanswered question is why the U.S. saving rate is so low. Many economists blame the low rate on government policies, which they believe generate a fear of saving or a disincentive for saving. Some of the major policies are incorporated in tax laws. The social security system is another possible saving disincentive, as are other government retirement programs, which make saving seemingly unnecessary. Credit market rules, which have encouraged extensive borrowing and limited returns to small savers, have also been blamed for discouraging saving. Finally, economists cite government deficits and monetary policy as causes of a low saving rate.

Present tax laws affect personal saving in a number of ways. First, the deductibility of interest expense is an incentive for borrowing. Individuals borrow for two reasons — saving (investment) and consumption. Borrowing for saving has no effect on overall saving rates; that is, it is neutral toward savings. However, borrowing for consumption removes funds that can otherwise be used for saving or investment and is, therefore, anti-savings. The overall effect of the two types of borrowing then is anti-savings. The deduction of interest expense certainly provides a large disincentive for creating new saving, since income from saving is taxed and expenses of borrowing (dissaving) are deductible. Interestingly, what limits already exist in the tax code on deductibility of interest expense (sections 163(d), 265) restrict interest on investment borrowing but not on that for consumption. Thus, unpopular as it would be to many taxpayers, eliminating the consumer-loan-interest deduction would serve to increase saving relative to consumption.

A second area of the tax laws that discourages saving is the double (or more) taxation of savings: "first, when earned as income; and second, as the income from the investment that the saving generates comes in."[2] Savings may also be taxed a third time, from capital gains on the sale of assets purchased with savings (even if those gains are solely from inflation). David Raboy has summed this up in his testimony before a Senate subcommittee: "As a result, the tax system penalizes savings at both ends, it subsidizes those who dissave while taxing those who do save."[3]

A third potential disincentive to saving and investment is double taxation of corporate dividends, once when earned by the corporation and once when paid to shareholders. The *Blueprints* study has addressed this problem, and concluded that current tax rules have the effect of discouraging investment.

> The separate taxation of income earned in corporations is responsible for a number of serious economic distortions. It raises the overall rate of taxation on earnings from capital and so produces a bias against saving and investment. It inhibits the flow of saving to corporate equities relative to other forms of investment.[4]

The study notes that integration of corporate and individual taxes should serve to aid the problem of misallocation of resources created by double taxation and, hence, enhance investment. Integration could also aid in increasing personal saving by eliminating the double taxation of corporate dividends.

There are several alternatives that can alleviate the economic distortions caused by corporate taxation. One such approach would treat all corporations as partnerships and allocate corporate income to shareholders. This approach is theoretically ideal, but suffers from enormous record-keeping difficulties. Another would be to repeal the corporate tax altogether, which would carry major transition, equity, and political problems. Other alternatives include expanding the dividends-received exclusion and implementing a dividends-received credit. Such alternatives would not resolve the economic distortions, as corporations would still favor debt over equity.

Two alternatives that have received attention in prior years are the dividends-paid deduction and the "gross-up method." The dividends-paid deduction approach would allow a tax deduction to corporations for dividends distributed to shareholders and would thereby remove the disparities between debt and equity financing. (In limited form, this is the approach of the 1984 Treasury proposals.)[5] A problem with the deduction, however, is that it encourages distributions of earnings and, as such, may impede growth. Furthermore, the corporate tax would still exist for undistributed earnings and, as it does currently, may impede saving and investment to some extent.

Under the gross-up method, the shareholder includes in income dividends received and the corporate tax attributable to such dividends (gross-up). The shareholder is then allowed a tax credit for the amount of the gross-up. Under this method dividends would be more attractive to the investor than interest, and, hence, might enhance investment. Either of these methods, then, may serve to stimulate investment.

The availability of funds for capital formation may also be reduced by the interest expense deduction. Businesses certainly have an incentive to borrow for investment purposes. They receive the deduction for interest as well as the deduction for depreciation and the investment tax credit if the funds are used to purchase applicable property. However, individual taxpayers often favor housing and durable goods as investments over financial assets such as stocks and bonds. Taxpayers make such choices because borrowing for their purchases generates a tax deduction, and the flow of services from housing and durable goods is not taxed. It is not clear what the magnitude of the effect on investment is or to what extent investment would increase were the deduction removed. However, relative to a tax system with no personal-interest-expense deduction, the current system provides disincentives for investment.

The potential results of low saving and investment are the basis for the underlying assumption of this report that higher saving and investment are desirable. Martin Feldstein, former chairman of President Reagan's Council of Economic Advisers, has noted

> Increasing the rate of capital accumulation must remain one of the central and continuing long-run goals of economic policy. A higher rate of capital formation is the most dependable way to increase productivity and to raise our nation's rate of economic growth. . . . Our low rate of capital formation means that we as a nation are passing up the opportunity to earn a high rate of return and to raise our future standard of living.[6]

And, former Treasury Secretary William E. Simon writes the following:

> Our treatment of individual savings and investment income is in sharp contrast to the preferential tax treatment of such incomes in most other industrialized countries. [And] although our treatment of corporate capital income is especially severe, the tax code includes numerous tax breaks to specific kinds of capital income that service to misallocate our limited investment resources. . . . All of this is done for the purpose of meeting specific social objectives that might otherwise be neglected. There is, however, little hard evidence to show that such concessions are successful in meeting their goals or that the benefits that follow exceed the costs associated with the misallocation of our scarce capital resources.[7]

These are profound implications, indeed — the United States has typically been a world leader in developing new technologies, increasing output and living standards, and the like; declining investment is already showing signs of diminishing that position. Hence, it is important to look to alternatives for improving saving and investment in the United States — and, it is hoped, thereby improving capital formation and productivity. Our tax system can play an important role in this process, and it is to that end that the following discussion is aimed.

Chapter 2

ALTERNATIVE TAX SYSTEMS

As a starting point for focusing on use of the tax system to encourage saving relative to consumption, the chart on the next page illustrates possible primary tax systems. This section contains a brief discussion of each alternative and reasons for excluding or including the alternative in the report.

When considering an alternative tax system or proposing changes to the present one, several issues require attention. The first is whether the base should be income or non-income — where a non-income base may be measured by expenditures, value, or receipts. The second issue, once a base has been chosen, is its breadth — from very narrow to comprehensive. The present U.S. system lies somewhere between the extremes, as do most current proposals.

A third issue is the rate structure to be coupled with the base. The structure can range from nonprogressive (either regressive or "flat") to steeply progressive. When transactional taxes are considered, the choice is between a single rate or a multi-rate structure. Finally, the timing of taxation must be considered. The current U.S. system taxes on a periodic basis, whereas some systems tax by transaction or on a cumulative basis. Each of the tax systems reflected in the chart is briefly described in the following paragraphs, referenced to its corresponding number.

Chart References and Discussion of Alternative Tax Systems

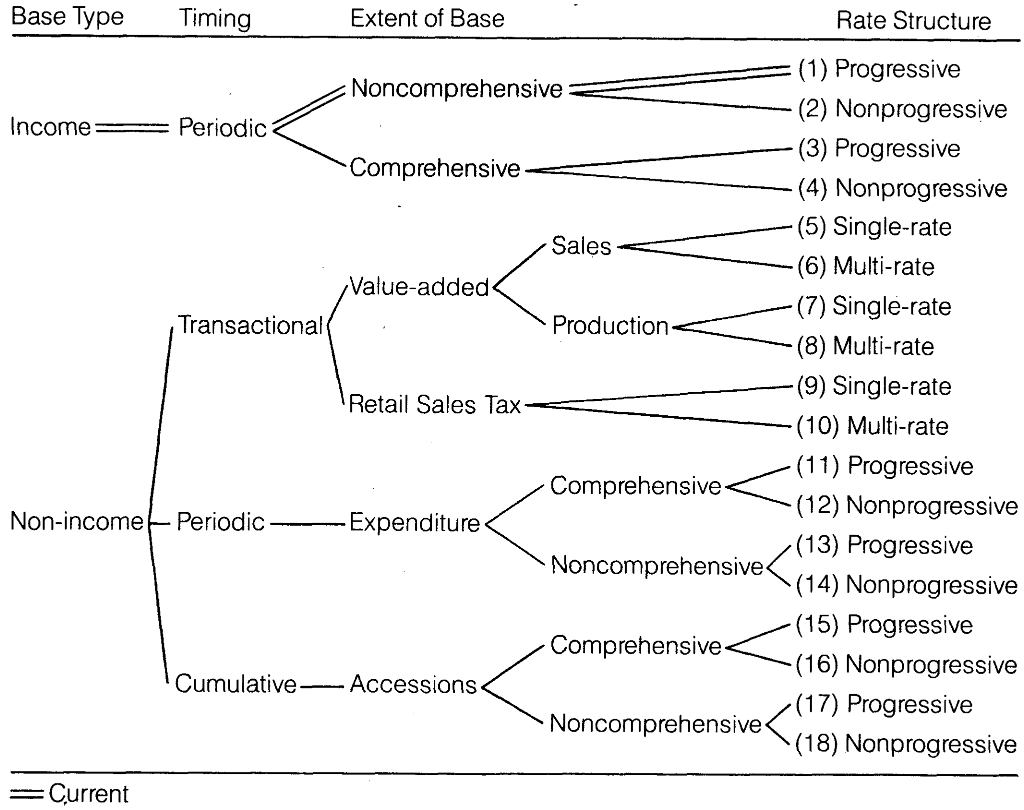
(1) The noncomprehensive-base, progressive-rate tax system defines the current U.S. income tax. Our system already includes some incentives for saving, such as Individual Retirement Accounts (IRAs), nontaxation of life insurance cash-surrender value, limited dividend exclusion, and so on. The system also includes some major saving disincentives, discussed in the introduction to this report.

(2) Maintaining a noncomprehensive base and instituting a nonprogressive rate structure would most likely have the effect of redistributing the tax burden from high-bracket to low-bracket taxpayers and are unlikely to improve upon the current system. Although such a structure would probably increase saving and investment, the redistribution of the tax burden makes this politically infeasible; therefore, this alternative is not considered further.

(3) The 1984 Treasury proposals and the 1985 Bradley-Gephardt bill (S. 409, H.R. 800 (99th Cong.)) are examples of a comprehensive, somewhat progressive income tax system wherein individuals are subject to a three-tiered rate structure on a base that is broadened through the elimination of many special provisions. This type of tax system will be discussed in chapter 3. Note also that a comprehensive base and progressive rate structure can be used with an expenditure base, as in the Hall-Rabushka proposal (see chapter 4).

(4) Examples of the comprehensive, nonprogressive income tax system are represented by Senator Helms's bill (S. 2200 (97th Cong.)) and the Siliander-Nickles "Flat 10" bill (H.R. 200 (99th Cong.)) and, for individuals at least, the 1985 Kemp-Kasten bill (S. 325, H.R. 777 (99th Cong.)), all of which impose tax at a single rate.[8] (Because such systems

Primary Tax Systems



have the potential to create savings incentives, they will be discussed in chapter 3.) The principal distinction between the progressive and nonprogressive systems of (3) and (4) on the chart (that is, progressivity) involves the issue of "vertical equity" in the parlance of tax policymakers, known better to laymen as "ability to pay."

(5)–(10) A value-added tax (VAT) is a transactional consumption tax, levied on each firm in the production and distribution chain, from the acquisition of raw materials through the final sale to a customer. In concept, the tax is applied only to the value added by the company, that is, to the excess of its sales over its purchases of goods or services from other business firms. A sales tax is simply a single-stage VAT applied at the retail level only, and many of the advantages and disadvantages claimed for a VAT apply equally to a sales tax. (Transactional consumption taxes are discussed in chapter 5.)

(11)–(14) A periodic-expenditure tax system taxes consumption, which can be thought of as income less savings (or plus negative savings). Because income is the starting point for defining consumption, the issue of comprehensiveness versus noncomprehensiveness is basically the same as it was for an income tax. Major differences between expenditure and income taxes are in the treatment of items that go into the concept of saving or dissaving, since the periodic-consumption tax base allows a deduction for net savings. The noncomprehensive structure, which would allow the exclusion of "necessary" expenditures, may be more feasible politically. The rate structure issue is, again, the same as for an income tax system, wherein the considerations are mainly of vertical equity. (Periodic taxes on consumption are analyzed in chapter 4.)

(15)–(18) An accessions tax is imposed on all incoming cash flows that are not taxed by an income tax, if one exists, or all cash flows, if no income tax system is present. As such, the tax appears to be neutral regarding saving versus consumption; that is, cash flows are taxed as the taxpayer "accedes" to them, and beyond that point the taxpayer has no tax incentive either to save or consume. Savers and consumers who receive the same cash flows are treated equally by the system. Because this report addresses only those tax systems that encourage saving relative to consumption, no separate discussion concerning the accessions tax is considered necessary.

Chapter 3

COMPREHENSIVE-INCOME TAX

The term *comprehensive-income tax* has been used to mean everything from a flat-rate, nearly comprehensive system to a progressive rate, semi-comprehensive system. The modifier *comprehensive* accurately refers only to the extent of the taxable base, although many have used it to refer to a certain rate structure as well.

Proponents of the comprehensive income tax argue that people would save more because marginal rates would be lower.[9] Some, however, suggest that the opposite may occur. Because rates would be lower, taxes would take a smaller portion of savings than they currently do, so that one would need to save less to maintain a certain level of after-tax savings.[10]

The notion of making the taxable base more comprehensive through "broadening" is far from unknown to tax reformers. For example, the Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984 are primarily base-broadening efforts with few changes in tax rates. The first part of this section discusses the characteristics of a comprehensive base. The second part discusses tax base broadening combined with rate revision — the effects of a flat-rate tax versus a moderately progressive schedule. Throughout this chapter, reference is made to the 1984 Treasury proposals and other legislative proposals where appropriate.

Comprehensive Base

Arnold C. Harberger made the following point in an address to the American Council for Capital Formation:

> Theoretically . . . [the comprehensive] income tax would tax individuals . . . on all income, whatever the source, including wages and salaries, in-kind compensation, and the real increase in the net worth of all investments.[11]

A comprehensive base system would essentially do away with most current deductions and credits. Only a basic sustenance level of income would go untaxed through the retention of personal and dependency exemptions. Most economic inflows provide, directly or indirectly, the means for a taxpayer to consume or save and would be included in the taxable base. The tax base would include such partially excluded items as capital gains, as well as transfer payments from the government, such as unemployment insurance, social security, supplementary unemployment income, and the like. Capital gains would be indexed to reflect the impact of inflation, as would deductions for depreciation. A comprehensive base would tax more in-kind income than the current base, but the difficulty and complexity of imputing the appropriate monetary value to items such as the imputed rental value of homeowner's capital investments may make full taxation infeasible.[12]

The advantages of a comprehensive base are the following: (1) the tax rates needed to raise a given amount of revenue can be lower because the more income is subject to tax; (2) economic efficiency is increased by removing distortions caused by tax preferences; (3)

complexity is reduced by eliminating the multitude of deductions and credits; and (4) fairness is increased by putting the same burdens on taxpayers in similar economic circumstances. The Treasury proposal notes the following:

> A comprehensive definition of taxable income or consumption is generally conducive to simplicity and to equal treatment of equally situated taxpayers, while retreat from a comprehensive base generally involves complexity and horizontal inequity. A comprehensive tax base is also necessary for economic neutrality, since high tax rates and discrimination between various ways of earning and spending income distort economic decisions.[13]

A truly comprehensive base can go far in removing political and social factors from the federal tax system, merely from the repeal of many preferences included in our present system that give incentives to particular social or economic behavior. While this may prove a major benefit of a comprehensive base, it would always be subject to the self-discipline of future Congresses.

Lower Tax Rates

Because a comprehensive base is broader, rates may be lowered, and the system will still produce the same revenues. For instance, if adjusted gross income is used as a base (on 1984 projected figures), but with capital gains fully included, a flat rate of 11.8 percent would raise the same amount of revenues as the current system. If taxable income (less zero bracket amount) is used, a flat rate of 18.5 percent would be sufficient.[14] Note that the latter example is not one of base broadening, but merely the result of a shift to a flat-rate structure. One can contrast these figures to the top marginal rate of 50 percent in the current system.

Efficiency

The current system of tax preferences for various favored types of income and expenditures produces economic distortions in two ways. First, if the income from some particular economic activity is either excused from taxation, or taxed at some preferential rate, then the activity is more attractive to taxpayers. Resources tend to flow into the tax-preferred activity from other activities with higher pretax returns, with the result — as viewed by some — that the real value of the economy's output is reduced.[15]

This line of reasoning implies a second efficiency cost when these exceptions to the tax base begin to multiply and grow. As tax-preferred income increases as a share of the total, and fully taxed income therefore shrinks, the tax rates needed to meet the government's revenue needs rise. Thus, the after-tax reward for all non-tax-preferred activities, which generally includes work and much of saving, falls.[16]

The proponents of a comprehensive base maintain that the solution to these problems of economic inefficiency is to broaden the tax base by repealing the tax preferences for the various favored types of income and expenditures. A comprehensive base is more neutral than the present system regarding investment decisions, leading to a greater flow of investment funds to areas in which they are most productive, rather than to areas in which they earn the highest rate of after-tax return. Some argue that a comprehensive system would therefore enhance economic efficiency. For instance, William Simon notes that "it would eliminate the grossly inefficient misallocation of capital resources that occurs in the present system, where the pattern of investment is determined as much by anomalies in the tax law as by their true productivity."[17] Without the tax preferences, resources would be allocated according to the before-tax social return, and marginal tax rates could be reduced.[18]

This is not to say that all deductions or tax preferences should be summarily eliminated. First, to the extent one believes that these preferences serve desirable objectives and are more effective than other means of advancing them, a significant offsetting social cost might have to be attributed to more comprehensive taxation.[19] But also social benefits in reducing political special-interest lobbying costs may occur because there would be a general hesitancy to carve exceptions into a purely comprehensive base.

Second, it would be essential to retain in the law those deductions necessary to measure income correctly.[20] For example, an income tax on a small business that does not allow a deduction for depreciation of a business computer or other office equipment can result in the assessment of an income tax on a business that, by current income-measurement standards, only breaks even, or even loses money. The end result would be to discourage business undertakings in which the nondeductible expenses are important. So, while broadening the tax base generally increases economic efficiency, this benefit is lost if the tax base is broadened beyond the measure of true economic income.[21]

Simplicity

Broadening the tax base is often portrayed as the ultimate simplification. The Treasury proposal notes the following:

> Simplicity is not wondering which receipts and checks to save because the tax law is too complex and is constantly changing. Simplicity is not computing dozens of deductions and credits, and wondering all the while whether other means of saving tax might have been missed through ignorance of the laws.... A simple tax system would not require 41% of all taxpayers — and about 60% of those who itemize deductions — to engage professional assistance in preparing their tax returns.[22]

The "pure" comprehensive system should be less complex for taxpayers and the administration. Under present law, "the proliferation and expansion of exclusions, adjustments to income, deductions, and credits create a major burden of paperwork and make part-time bookkeepers of many Americans."[23] The caveat here is that, depending on the comprehensiveness of the base, the system would add some complexity — for example, in the determination of values of fringe benefits, in-kind compensation, and so on. It is difficult to predict how the administrative aspect of taxation would be affected by this change; however, many proponents claim simplicity to be a major strength of the comprehensive tax.[24]

Fairness

Fairness is one of the advantages of base broadening most often mentioned. One perceived standard of fairness is the treatment of taxpayers at similar income levels. The Treasury proposal notes this:

> A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair....If some items of income are omitted from the tax base, or if particular expenditures are treated preferentially, then taxpayers who are otherwise in equal positions will not be treated equally.[25]

Thus, the elimination of tax preferences that cause extreme differences in tax burdens among similarly situated taxpayers can help to restore confidence in the fairness of the system.

The elimination of these tax preferences would also enhance fairness with respect to the tax treatment across income classes. Fairness across income classes is the notion that those with high incomes should pay a greater percentage of their income in tax than those with intermediate levels of income. The 1984 Treasury proposal states the following:

> Defining the tax base comprehensively is necessary for the achievement of equity across income classes. Any exclusion of deduction is worth more, the higher the marginal tax bracket of the taxpayer. Moreover, wealthy taxpayers make relatively greater use of many provisions of the tax law that reduce the tax base, especially those yielding business deductions that result

in the mismeasurement of economic income and produce tax shelters. As long as these tax preferences exist, the tax system will be less progressive than the rate structure suggests, and high marginal rates will be advocated as a means of achieving progressive taxation.[26]

Another standard of fairness pertains to the lifetime burden of a taxpayer; for example, will different patterns of income or consumption alter the total tax burden over a long period of time? The current U.S. system, with its progressive rates and annual accounting period, may cause great discrepancies between taxpayers whose income and consumption patterns vary despite mechanisms, such as income averaging, designed to mitigate this undesirable result. Broader based systems with few deductions and flatter tax rates may tend even more to eliminate what many consider to be an undesirable and unfair result.

Some variation in tax burdens within income groups occurs today not because of manipulative tax avoidance by sophisticated investors but because of transactions such as home purchasing and charitable giving. Eliminating those tax preferences would narrow the variation in tax burdens, but it could also have various side-effects.[27] For example, the elimination of the mortgage interest deduction would not only increase the tax liability of most homeowners, but would also decrease the market value of most homes, thus creating serious problems for mortgagees who would hold over-valued mortgages.

In general, base broadening can yield substantial benefits, but all must be qualified to some extent. As for low tax rates, the Treasury proposal notes that "it is far better to levy low tax rates on all income than to impose high tax rates on only part of income."[28] But when statutory marginal tax rates are reduced and the tax base is broadened simultaneously, the effective marginal tax rate (the actual increase in tax resulting from an increase in income) may not decrease; the tax rate is lower, but more marginal income is subject to taxation.[29]

The efficiency case for base broadening is very strong in that eliminating tax influences in the marketplace would cause resources to be allocated to their best uses and marginal tax rates to be reduced, but it would be necessary to retain deductions required for a true measure of income. Eliminating deductions and credits would simplify the tax system, but adding hitherto missing income items to the tax base would complicate it.

Finally, fairness suggests that all income be taxed in the same way, but some persons who are by no means abusers of the current system — such as homeowners — might find the elimination of tax preferences distinctly unfair (at least, as they would define fairness).

Tax Base Broadening Combined With Rate Revision

Broadening the tax base is only the starting half of the analysis of a comprehensive income tax. The other important half is the progressiveness of the rate structure to be proposed. A nonprogressive rate structure may be thought of as more pro-savings, in that marginal saving is taxed at a single rate, as opposed to progressively higher rates. However, such a rate structure raises difficult political questions, and many have stated that a truly nonprogressive (that is, flat) rate tax could not be a feasible alternative because of its redistribution of the tax burden from high-bracket taxpayers to low-bracket taxpayers. For example, under current law, families with less than $20,000 of income pay 5.5 percent of all individual income taxes, while those with $100,000 or more of income pay 22.2 percent. Under a pure flat-rate tax of 16.8 percent, the $20,000 group would pay 9.5 percent of individual income taxes, while the $100,000 group would pay 16.3 percent. Vertical equity is a widely accepted, advocated concept that would be difficult to change.[30]

It is important to note, however, that the incidence of the tax burden is essentially independent of the structure of the tax system. A broad-based income tax system may be designed using personal exemptions, low income credits, and mildly progressive rates that will improve economic efficiency and still distribute the tax burden according to perceived social and political values. There would still be a shifting of tax burden from one taxpayer to another; however, material shifts from one income class to another may be avoided without undue complexity.

Finally, the effects on saving and economic efficiency of switching to a broader tax base, with lower progressive rates or a flat-rate structure, can be separated into two categories: those associated with differences between marginal tax rates on different activities and those associated with the levels of the marginal tax rates. To the extent that tax revision reduces differences in tax treatment of different sources or uses of income, tax-induced economic distortions would be diminished and economic efficiency would be improved.

The effects of reducing the overall level of marginal tax rates, however, are more ambiguous. Other things being equal, lower marginal tax rates should improve efficiency in individual decisions to work, save, and invest. With these tax revisions, however, other things would not be equal. As pointed out earlier, combining marginal rate reduction with base broadening will not necessarily decrease incremental tax because more marginal income is subject to taxation.[31]

Accretion Concept of Income

It should be noted that as the base is made more comprehensive it approaches the Haig-Simons definition, or the accretion concept of a tax base. Economists express the accretion system by the formula: $I = A + C$, where I equals income, A equals savings, or accretion in net worth, and C equals consumption. In a pure accretion system all assets would be inventoried each year, liabilities deducted, and the taxpayer's net worth determined at market value. The difference between the net worth amounts at the beginning and end of the accounting period reflects the net increase or decrease in the market value of the taxpayer's command over consumption. The taxpayer's expenditures for consumption for the period are added to this factor to produce the taxpayer's income for the year.

With respect to savings, the accretion concept of income has many shortcomings as a tax base. As *Blueprints* notes, an especially serious drawback of an accretion income base is that it leads to what is sometimes called the "double taxation" of savings; savings are accumulated after payment of taxes and the yield earned on those savings is then taxed again. *Blueprints* then goes on to point out that this has been recognized as a problem in the existing tax law and that the investment credit, accelerated depreciation, and the special tax rate for capital gains are techniques that have been introduced to make the tax system more neutral with respect to savings.[32]

Putting the accretion concept into the statutory language of the Internal Revenue Code means that adjusted gross income would be expanded to include items presently excluded by statute — tax-exempt interest, the full amount of capital gains and losses, gifts and bequests, and the like — and it would be further expanded to include the unrealized gains and losses attributable to the taxpayer's net assets. Many of the current proposals discussed in the next section incorporate these accretion-type adjustments.

Approaches to a Progressive Comprehensive-Income Tax

The Treasury proposal, the Bradley-Gephardt Bill (S. 409, H.R. 800, (99th Cong.)), and various other proposals represent an effort to achieve a greatly broadened tax base combined with lower marginal tax rates. Both proposals have a three-tiered progressive rate structure and are revenue neutral in the sense that they would leave tax revenues essentially unchanged from what they would be under current law. Only a few deductions are allowed from the base, with the Treasury proposal the more restrictive.

In brief, the 1984 Treasury proposals would eliminate most special tax provisions for individuals such as the state and local tax deduction, dividend exclusion, and capital gains exclusion. It retains the home-mortgage-interest deduction, medical expense deduction, charitable contribution deduction, and IRA and Keogh deductions. Additionally, the proposal would index interest income, the personal interest deduction, and the costs of capital assets for inflation.

With respect to business, the proposal levies a 33 percent corporate tax rate. It eliminates most special tax provisions for corporations, such as the investment tax credit, percentage depletion and the intangible drilling-cost deduction, corporate capital gains, the ACRS (the proposal replaces ACRS with a new depreciation system known as the Real Cost Recovery System). It substantially modifies the research and development credit, the foreign tax credit, and interest expense. Also, the proposal allows corporations to deduct one-half of dividends paid out of previously taxed earnings.

The Bradley-Gephardt "Fair Tax" would retain the deduction for employee business expenses, home mortgage interest, charitable contributions, state and local income taxes, and real property taxes. Social security and veterans' benefits would remain tax-exempt. There would be modifications to certain current provisions, including the child care credit, the exclusion for employer-provided health insurance, the deduction for medical expenses (limited to expenses in excess of 10 percent of adjusted gross income) and the $125,000 exclusion of gain on the sale of a residence. Many other special exemptions, deductions, and credits presently available to individuals — such as those for percentage depletion, intangible drilling costs, and the investment credit — would be repealed. The entire amount of capital gains (without any excludable portion) would be subject to tax. This proposal, like the Treasury proposal, while moving toward simplification, lower tax rates, and base broadening, is not a truly comprehensive income tax system. Instead, it is a partially comprehensive one aimed at curbing certain investment incentives in our current system that are perceived as being abusive or excessive.

Approaches to a Nonprogressive Comprehensive-Income Tax

The Helms Bill (S. 2200 (97th Cong.)) is a very broad-based income tax, more correctly called a comprehensive-income tax, deleting most current preferences (deductions, exclusions, and credits). Special treatment for capital gains is eliminated, and other forms of income that are currently partially or totally exempt would be taxed. Gifts and inheritances would be included in the tax base, so beneficiaries and recipients would be subject to an annual tax with no provision for current estate and gift deductions and credits. This new, expanded base would be subject to a flat 10 percent rate.

The Siljander-Nickles "Flat 10" (H.R. 200 (99th Cong.)) would broaden the tax base and impose a flat 10 percent tax rate. Flat 10 would also index the personal exemption for inflation but would not make any revisions to the current corporate tax law. It would eliminate most special tax provisions for individuals, such as the dividend exclusion, the homeowner exclusion of up to $125,000 of the gain on the sale of a residence, the medical expense deduction, and the capital gains exclusion. Flat 10 would retain the home mortgage interest deduction, personal interest deduction, state and local tax deductions, charitable contribution deduction, and IRA and Keogh deductions. Finally, Flat 10 is designed to raise approximately the same amount of revenue as our current federal tax system.

The Kemp-Kasten "Fair and Simple Tax Act" (S. 325, H.R. 777 (99th Cong.)) would dramatically simplify the present system by broadening the base substantially and lowering the rate to 25 percent for individuals. However, the plan would retain many popular deductions, including mortgage interest, charitable contributions, accelerated cost recovery, and the tax-favored treatment of retirement savings and fringe benefits. The investment tax credit and other credit incentives would be eliminated. The Kemp-Kasten plan addresses the inherent regressivity issue with a special exclusion: 20 percent of salary in the social security wage base (now slightly in excess of $39,000) would be excluded and not subject to the flat 25 percent rate. As income rises above the wage base, the excluded portion would be added back into the tax base at a 12.5 percent rate, raising the marginal rate on earned income to as high as 28.4 percent [25 percent + (25 percent x 12.5 percent)].

Impact on Savings and Capital Formation

The table highlights some of the features of the Treasury proposal, Bradley-Gephardt, and Kemp-Kasten with respect to savings and capital formation.[33]

Table 5

Treatment of Capital Formation

Feature	*Treasury Proposal*	*Bradley-Gephardt*	*Kemp-Kasten*
Depreciation	Economic	Modified ADR	NCRS
Investment tax credit	No	No	No
Indexation			
Depreciation	Yes	No	No
Inventory	Yes	No	No
Interest	Yes	No	No
Capital Assets	Yes	No	Yes
Distinction in Tax Rates for Capital Gains	No	No	Yes

One can quickly grasp from the table what the primary omissions are under each proposal. The Bradley-Gephardt bill fails to take into account the effects of changes in the general price level (except to the extent that depreciation deductions are accelerated) using the 250-percent declining-balance method. "Such a system in an inflationary economy would eventually lead to substantial distortions in the measurement of the tax base," Pamela B. Gann has written in *Tax Notes.*[34] The Kemp-Kasten bill, on the other hand, provides for partial capital gains indexation. (The basis of a capital asset is indexed for inflation. However, during a ten-year transition period, taxpayers may choose between an exclusion of 25 percent of net capital gains or indexation of basis.) Ms. Gann believes that "it too would substantially mismeasure the tax base, from both the ad hoc nature of the ACRS depreciation system and the decision to index only capital assets for inflation."[35] In contrast, the 1984 Treasury proposals are designed to achieve a more neutral taxation of capital income.

It must be remembered, however, that a comprehensive income tax is still an income tax, not a consumption tax, and these proposals would not eliminate the harm to saving that is inherent in any accretion tax. To the extent that the rates under a comprehensive income tax are lower than the rates under the present tax, the comprehensive income tax may be less detrimental to saving than the present tax. However, to take one example, the elimination of the capital gains exclusion means that the tax rates on some aspects of investment will be higher rather than lower. Thus, the comprehensive income tax proposals are unlikely to truly solve the problem of comparatively low savings levels in our economy.

Potential Problems of a New System

The foregoing discussion has focused, for the most part, on the merits of an alternative, broad-based tax system. However, proponents of the current system see significant problems that would be inherent in any broad-based system. Some of the potential costs of these alternatives, then, should be considered along with the benefits.

For example, in addition to general changes in investment incentives caused by base broadening, reducing progressivity in the tax system might adversely affect municipal bond funding and ownership. There could be a loss of asset values since the current investment tax base (that is, buildings, plant, and equipment) would no longer provide the same levels of tax benefits through investment tax credits and accelerated depreciation. Cash flow problems may arise because fringe benefits are deferred, and retirement benefits may be taxed currently at fair market value.

A broad-based tax system would also have a potential for regressivity because of the use of a uniform rate. There would probably be a reduction in charitable contributions, and many industries would be affected by the elimination of their special tax advantages. Finally, state and local tax revenues would almost certainly change because of state-income-tax linkage to a federal tax system.

The Problem of Transition

Evaluation of the relative benefits and costs of alternative systems is only part of the process in deciding whether to make a major change. Behavior patterns within the society, investment decisions, financing practices, and social relationships have been based, in many respects, on the existing tax system. What effect a major restructuring of the tax system would have on these relationships and investments during the transition phase must, of course, be considered. In short, even if an alternative system clearly is more beneficial, are the costs and complexities of making the change acceptable?

To the extent that any change in the system would disallow deductions or increase income with respect to investments made before enactment of a new tax system, it is evident that serious economic displacement can occur unless there is a substantial transitional period. But even with phase-ins or grandfathering, a new tax system would bring with it large windfall losses in the values of many assets. Even if home-mortgage-interest deductions were phased out over several years, for instance, homeowners might still suffer an immediate drop in the value of their houses.[36] Thus, loss of expected tax benefits with respect to investments will almost certainly create a reduction in portfolio asset values.

Some are even concerned that a taxpayer revolt may result from a significant diminution of wealth and have suggested the necessity for a lengthy phase-in period — up to twenty or thirty years for those who have homes as well as other investments subject to long-term mortgages. Transactions entered into after enactment of a new system would be subject to the new system at the time of the transaction. Transactions initiated before the date would be grandfathered to assure investment maintenance. (The Treasury proposals, while recognizing the need for liberal transition rules, do not come close to the type of liberality described above.)

Inherent in all of this, of course, is the problem that detailed records must be maintained. Furthermore, the very existence of transitional rules could create a situation of utmost complexity: two different systems of taxation operating in parallel for some period of time!

Political Considerations

The perceived political disadvantages of a comprehensive system may be great. The first problem occurs in those systems that propose "flat" rates. Richard Goode puts it this way: "I do not believe that the country is willing to accept [redistribution of taxes under a flat tax] and to discard a feature of the income tax that is essential to reach ability to pay, that has been present in the U.S. tax for the past 70 years."[37] Or as Joseph Minarik notes, "taxpayers with higher incomes are assumed to buy nonessentials with their last dollars of income; those with lower incomes are assumed to buy more basic items. It might follow, then, that persons with higher incomes could afford to pay tax at a higher rate."[38] Indeed, the 1984 Treasury proposal recommended against a revenue-neutral flat-rate tax because of "the massive redistribution of tax burdens a pure flat tax would produce."[39] But it should be noted that "though a majority of the population appears to favor progressivity on grounds of fairness ... there is probably no agreement within that majority as to just how progressive the tax system should be."[40]

The second political problem arises from the potential elimination of deductions. Although, when surveyed, a majority of individuals favor a comprehensive income tax, they also favor maintaining the deductions they currently use. The CBO's publication *Revising the Tax* puts it clearly: "Every special deduction, exemption, exclusion, and tax credit has a well-formed constituency, and many institutions, industries, and individuals feel dependent on these provisions for their financial well-being."[41] Furthermore, corporations depend heavily on tax incentives and credits as support for increasing production and capital investment. Dependence by both individuals and corporations is strong enough so that political pressures preserving one or the other favorite provision make the passage of the broadened-base tax difficult to accomplish.

Even if the political obstacles can be overcome so that a comprehensive system was instituted, the system would still be subject to changes. Rates would probably be lowered in a comprehensive tax. To raise more revenues, Congress would be tempted subsequently to raise rates or add surcharges — possibly back to former nominal levels. Should this happen, the comprehensive system will have served as the vehicle to raise the tax level rather than serving its presently stated purposes.

The new tax would impose what can be tantamount to a revolutionary change, which may be disruptive economically and administratively. To the extent that such a change requires grandfather clauses and a lengthy transition period with parallel systems, it would be very difficult to administer. Furthermore, even though the broad-based tax (in a pure sense) would be pro-savings relative to the current system (because marginal rates would be lower), it is doubtful that a pure system would be considered because of its redistribution of the tax burden. For these practical reasons, then, the task force cannot state that such a revolutionary change is the best choice for encouraging saving relative to consumption. Gradual changes to the current system may be a better alternative.

Chapter 4

PERIODIC CONSUMPTION TAX

The idea of taxing consumption dates to 1651, when Thomas Hobbes wrote the following: "For what reason is there, that he which laboureth much, and sparing the fruits of his labor, consumeth little, should be more charged, than he that living idely [*sic*] getting little, and spendeth all he gets: seeing the one hath no more protection from the Commonwealth than the other?"[42] Income has traditionally been perceived as the primary indicator of an ability to pay taxes; but since the seventeenth century there have been those who argue that what a person consumes is better evidence of well-being than what is received as income. A person's ability to consume is determined by both income and wealth and changes depending on whether income is constant and certain or is irregular and uncertain. Consumption, however, tends to be much smoother than income and can therefore be considered a much better index of "ability to pay." Many economists and political philosophers have followed Hobbes's lead, asserting that income may be seen as a rough measure of what a person contributes to society (via labor, investment, and so on). Consequently, consumption may be viewed as a rough measure of what a person withdraws from society. These thinkers believe that it is more equitable to tax consumption than income.

Consumption taxes can be fashioned in many different ways. An expenditure (or "consumed income" as it is labeled in the Treasury proposals) tax is levied on the total consumption expenditures of the individual; a sales tax is levied on the sales of goods and services; and a value-added tax is levied on the difference between a firm's sales and its purchases. Consumed-income taxes may be proportional or progressive; sales and value-added taxes may be imposed at a uniform rate on all commodities or at differing rates on various groups of commodities. Consumed-income taxes are collected from the consumer; sales and value-added taxes are collected from the seller. All three varieties of taxes will be discussed.

Basic Concepts of a Tax on Consumed Income

Simply stated, the base of the consumed income tax is the part of the individual's income that is spent in the taxable year for consumption purposes. Keeping track of one's consumption outlays over a year's time is the most direct measurement of consumed income, but a much simpler approach is available. By starting with the proposition that comprehensive income includes any monetary benefit that can be used either for consumption or net savings, consumed income may be determined simply by subtracting net savings (which is the same as the change in net worth — that is, the change in one's assets less the change in one's liabilities) from comprehensive income.

If it is accepted that the base in a consumed-income tax system starts with comprehensive income less savings (or plus negative savings), two problems are encountered — defining the comprehensive-income base and defining savings. To avoid the problems of a comprehensive-income definition in relation to a consumption-based tax, *Blueprints,* Aaron and Galper's lifetime income tax, and many other statements on the subject adopt a cash-flow tax. In very basic terms, the comprehensive-tax base would be determined by including all cash inflows and deducting all cash outflows allocated to saving or investment. The balance would represent consumption, and tax would be paid on that amount less appropriate exemptions.

Because of the difficulties inherent in accounting for saving or consumption when housing or consumer durable goods (for example, automobiles) are concerned, *Blueprints* presents a concept that can be central to the operation of a periodic consumption tax: the qualified account and the nonqualified/tax-prepayment account.[43] A qualified account would be similar to an IRA: It can be established by any financial institution (including a brokerage) that keeps records of deposits and withdrawals. The account would be permitted to buy and sell any type of financial asset (stocks, bonds, savings deposits, stock or mutual funds, futures, and the like). Investment yield (including *realized* appreciation) would escape tax altogether. A taxpayer's additions to a qualified account would be deductible from the current tax base. A comparison of an individual's balance in a qualified account at the beginning and at the end of the tax period would determine whether that person was a net saver or dissaver over the accounting period.

Unlike the procedure with an IRA, however, a taxpayer may withdraw from the qualified account at any time and for any reason. There would be no limits to the amounts contributed or withdrawn; however, *any* withdrawal from a qualified account is included in the tax base for the year withdrawn. No distinction is made between "principal" and "income." Of course, to the extent funds are reinvested in a similar account, a corresponding deduction is permitted.

For example, an individual deposits $100 in a qualified savings-bank account, where it earns 10 percent annual interest. In the year the $100 is deposited, the individual would be allowed to deduct $100 from current receipts in computing a tax base. If, in the following year, the taxpayer withdraws the principal plus the earned interest—now equal to $110—that amount would be added to receipts from other sources in computing the tax base. If the savings deposit were left in the bank instead to accumulate interest, there would be no current tax consequences. Any future withdrawal would add to taxable receipts in the year it is made.

The concept of a nonqualified account is introduced to handle problems occurring with major consumption purchases when the use of qualified accounts may prove cumbersome. For example, personal housing has been considered a consumption item rather than a savings item by various commentators. An example to consider would be that of a young, wage-earning couple, saving for the downpayment on their first home. If the amount saved from earnings in each of the past years was placed into a qualified account, the amount has avoided tax on that part of earnings; however, removal of the downpayment from a qualified account in one year will subject the entire amount of that payment to tax. Depending on the marginal rate structure, much of that tax may be at a higher bracket than the deduction for the original deposit to the qualified account.

To avoid this type of problem, not only for housing but for other consumer durable goods, *Blueprints* proposes permitting taxpayers to make deposits into so-called prepaid accounts. The wage-earning individual placing $100 in a nonqualified savings account *would not* receive a deduction for that $100 and, accordingly, would "prepay" the tax on that amount, even though it has been put into savings.[44] However, neither the principal amount *nor any earnings on it* would be subject to tax when withdrawn from the account. Investments from nonqualified accounts would occur outside the tax system. Thus, no tax is incurred when the nonqualified account funds are used toward the purchase of a new home.

The *Blueprints* study presents an analysis showing that the present value of prepayment accounting and qualified account treatment is identical to both the government and the taxpayer, barring changes in tax rates between the two years involved.[45] An example will illustrate this. An individual in the 40-percent bracket deposits $100 in an investment account in year one, at a 10-percent annual interest rate; this person withdraws the $110 of accumulated funds from the account in year two with a 40-percent marginal tax rate to use on consumption. If the qualified-account approach was used, the government would collect no tax in year one but would collect $44 of tax in year two, leaving the individual with the after-tax amount of $66. On the other hand, if the $100 was deposited in a prepaid account in year one, a tax of $40 would be collected in year one but no tax would be collected in year two (with prepaid accounts, the incremental earnings escape additional tax). However, the government would have achieved 10-percent earnings on the collected tax during the second year, so it still has $44 by the end of the second year. The individual, at the end of year two, has $110 in the account but has paid $40 of tax in year one and has forgone 10-percent earnings on that tax liability in the second year. Economically, that person is left $66 after tax. Thus, at the end of year two, both the individual taxpayer and the government are in equivalent economic positions, regardless of whether qualified or prepaid accounts are utilized.

Illustrations of Tax-Base Components

The table below lists some of the cash inflow and outflow items that would be important in arriving at a consumption-tax base. The discussion that follows elaborates on the treatment of some of the more important items. The policy that the table and discussion seek to demonstrate is the inclusion of broadly defined income and a deduction for investment and saving outflows.

(The discussion following the table relates back to the numbers of the table: arabic for cash inflows, roman for outflows.)

Table 6

Consumption-Tax Inflows and Outflows

	Inflows		*Outflows*
(1)	Wages, dividends, interest, rents		
(2)	Sale of investment assets		
(3)	Gifts and bequests	(iii)	Gifts and bequests
(4)	Unemployment compensation, fringe benefits	(iv)	Contributions to plans
(5)	Consumer durables		
(6)	Loan proceeds		
(7)	Life insurance proceeds	(vii)	Life insurance premiums
(8)	Unincorporated business income	(viii)	Business expenditures
(9)	Qualified account withdrawals	(ix)	Qualified account contributions
		(x)	Charitable contributions
		(xi)	Necessary expenditures
		(xii)	State and local income taxes

Although it may be apparent to the reader why certain items are taxed or not in a consumption-based system, the discussion to follow highlights particular items that merit elaboration.

(2) *Sale of investment assets.* Sales proceeds would be includable in the base in full; no attempt would be made to determine income or loss as is done under our present system. The theory is that a deduction would have been allowed for the full cost of the investment when made, and the sales proceeds are now available in full for consumption. To the extent a reinvestment of all or part of the proceeds in new savings takes place, a deduction occurs from the base for the current year.

(3, iii) *Gifts.* One option is to treat gifts as being includable by the donee and deductible by the donor. This is defended on the grounds that the donated assets are no longer available to the donor but are available to the donee for consumption. By including the gift in the tax base of the recipient, however, the burden shifts to the donee to avoid tax on that amount. This would be done by reinvesting part or all of the gift in a deductible fashion, such as in a qualified account, or by selling gifted property to raise funds for the tax liability. It can also provide an opportunity for planning (or abusing, depending on the perspective) intergeneration transfers, with high-bracket parents making gifts to low-bracket children.

If funds for the gift are withdrawn from a qualified account, the withdrawal requires inclusion of that amount in the tax base, and the gift merely results in a zero liability on those funds. If funds for the gift come from a prepaid or nonqualified account, the donor may use that deduction to shelter other income.

Another option would be to have the donor "prepay" the consumption tax on the amount transferred. Because the tax has already been paid, the donee would not have to pay any further taxes on either the transfer or on any returns earned by saving it. This option, however, adds a degree of record-keeping complexity: The donee must segregate the returns on the transferred property from all other investment income.[46] This method, however, eliminates a major criticism of the first option — that is, the system's tolerance of the "wealthy miser" who would almost completely escape tax under a tax on consumed income.[47]

A third option would be to include the gift in the tax base of both donor and donee. This would make lifetime income the base of the consumed-income tax.[48] However, this option also amounts to double taxation of the gift — in essence, deeming the act of making the transfer a type of consumption.[49] The lifetime income tax adopts this option, but such a method subjects the amounts bequested to an averaging provision if the amounts transferred are large relative to annual income.

(3,iii) *Bequests.* Includable by recipients, but deductible by the estate. Death continues to have tax consequences, even in a consumption-tax framework. Assets transferred by will now go into someone else's consumption base; and, to the extent this occurs by terminating the decedent's interest in a qualified account, income and deduction will match.

However, when certain assets pass from a nonqualified account, the consumption tax on the assets has been prepaid by the decedent on assets that will not be consumed. The concept of equity may require a tax-refund mechanism being established (perhaps by using an averaging convention for a period of years in determining the bracket). An alternative approach is permitting acquisition of those assets by heirs without inclusion in the heirs' tax base (possibly, by allowing transfer into a prepaid account of the heir).

(5) *Consumer durables.* Because consumer durables like homes, autos, or major appliances provide flows of services over periods of years that are not readily measured in dollars (imputed rent, imputed transportion costs, and so forth) a practical — if not theoretically correct — approach to dealing with such items is to treat their costs as current consumption. Thus, no deduction would be permitted for costs of acquisition, but no tax would be imposed on funds obtained from their sale.

The theoretical error in this approach is the forced prepayment of tax on future years' consumption during the current year. For example, an automobile purchased for $8,000 is expected to last for four or five years. Yet, by not permitting any deduction for a part of that $8,000, the future value of that consumption is currently subject to tax. However, with an automobile or appliances, it may be argued that either the life of the asset or its cost is small enough so that the prepayment is a low price to pay for simplicity. In the case of the home, however, financing the purchase with borrowing and the use of nonqualified accounts permits the distortions to be minimized or eliminated.

(6) *Loan proceeds.* An important advantage of the qualified/nonqualified alternative is seen in the treatment of borrowing. In this context, it is expected that financing transactions may occur through either qualified or prepaid accounts, and depending on an individual's

creditworthiness, loans can be made for substantially more than the balance in an account — resulting in both qualified and prepaid accounts with negative balances.

To the extent that a loan is taken from a qualified account, the proceeds are included in the consumption-tax base (a deduction is permitted for proceeds reinvested in some aspect of saving). Earlier in this chapter, discussion focused on the downpayment portion of home ownership.In actuality, the bigger problem (because of relative dollars involved) arises with the mortgage on the remaining purchase price. If the taxpayer takes out a mortgage loan by means of a qualified account, he or she will have created a large inclusion in tax base without an offsetting deduction because the proceeds are considered used for consumption.

The nonqualified-account alternative permits significant loans for the purchase of such goods as homes or automobiles without substantial tax payments in the year of borrowing. Neither principal nor interest is deductible on repayment, but the tax on consumption represented by use of the home or automobile is essentially deferred and paid during the period of use.

In general, it should be noted that nonbusiness interest would not be deductible. The exception occurs when the loan giving rise to the interest liability was taken by means of a qualified account because the loan proceeds were subject to tax in the year of the loan. In that event, even though loan proceeds were used for consumption purposes (college tuition, for example), both principal and interest repayments would be deductible as additions to a qualified account.

(7,vii) *Life insurance.* These funds would be included in the tax base under two theories: (1) Under general definitions of broadly based income, similar to gifts and bequests, they would be considered includable; (2) a life insurance policy would be seen as a saving or investment vehicle and premium payments would be, therefore, deductible.[50] All premiums paid by policyholders for whole life insurance would be tax deductible, while premiums paid by employers for policyholders would not be imputed to policyholder's tax bases. All receipts from life insurance policies would be included in the tax base of the recipient.

(8, viii) *Unincorporated business.* Gross receipts would be includable in the consumption-tax base. Business expenditures would be deductible in full, including capital investment. Theoretically, the amount allocated to savings or investment is the cost of assets being used in those sectors of the economy. To the extent that cost includes buildings or equipment, the amount of otherwise taxable inflows allocated to buildings or equipment should escape taxation.

As a practical matter, equipment and structures tend to be financed in some part through borrowing. To the degree that borrowing was done by means of a qualified account and the proceeds were invested in business property, there would be no current tax consequences. To the extent that an immediate windfall was sought by borrowing from a nonqualified/prepaid account with an immediate, deductible offset for investment in a business asset, limits on loss carrybacks or carryovers can still be part of our tax system, and future repayments (including interest) will be nondeductible.

Under this concept, depreciation will not come into play at all. With accounting for these costs handled completely through cash flows, there will be no need for depreciation allowances or accounting.

(x) *Charitable contributions.* A theoretical argument can be made, unlike that for state and local income taxes, that charitable contributions represent an individual decision on how to consume available funds; therefore, a deduction from the consumption tax base should not be allowed. An equally good argument can be made that contributions to charity do not benefit an individual directly, except as the overall betterment of society benefits each individual. Thus, charitable contributions may be seen as being more akin to gifts. The gift analogy fails if one assumes that it will not be followed through to the end user; that is, inasmuch as a charitable institution includes the amount of gifts in its tax base, the institution should obtain corresponding deductions on a social-policy, if not a saving or investment, basis. It is not practical to include the amounts expended by charitable organizations in the tax bases of their beneficiaries (students at a university, for instance). It would seem practical, however, to assume that any consumption-based system adopted in the United States would allow a deduction from the base for charitable contributions. This was the position adopted in *Blueprints.*[51]

(xi) *Necessary expenditures.* For social reasons that the body politic deems appropriate, the base would probably be reduced further by "necessary expenditures" (for example, food, shelter, medicine, and clothing). Such allowance may be made through standard deductions, exemptions, or both. Defining what "necessary" means may be difficult; however, the U.S. system incorporates items that were just as difficult to define but were specified accurately to satisfy Congresses in the past. Nevertheless, the theoretical consumption base is eroded to the extent such compromises are made.

Corporate Earnings Under *Blueprints*

Individuals consume; corporations do not. Thus, a comprehensive tax on consumption (unlike that on income) need not even wrestle with the problems of corporate earnings and how those earnings should be attributed to individual taxpayers. They should not; nor should the corporate tax system, then, be retained — at least, so goes this argument in *Blueprints.*[52]

The significant advantage from excluding corporations from the tax system altogether comes in giving them the ability to make business decisions unbiased by taxes. Economic consequences — not tax consequences — would thus drive the corporate decision-making process. The question of what is income that is subject either to tax or attribution to shareholders does not arise. Even in a broad-based, comprehensive-income tax system, where the corporate and individual subsystems are integrated, complex definitional problems of income remain because of the need to ascertain the amounts attributable to each corporate shareholder. No such problem arises in a consumption-based tax system.

Theoretically, the above argument may be correct; politically, it is likely to be untenable. The concept of corporations "escaping" tax is a politically sensitive one today. That sensitivity will doubtlessly not change merely because the tax system focuses on consumption rather than income.

Corporate Earnings Under the Lifetime Tax

As an alternative, the Aaron-Galper lifetime tax (which is consumption based) would have a two-part corporation tax.[53] The first would be a tax on cash flow. The corporation tax base would include total receipts of the corporation from all sources other than the sale of stock less all business expenses, including investment in the paid-for year. Deductions for business expenditures on consumption items for the benefit of employees or owners would be denied, and the business tax base would include the proceeds from borrowing. Corporations would be entitled to deduct all debt-service payments but no deductions for dividends or any other cash distribution to stockholders. If firms borrowed to finance investment, no tax would result in the year the investment was made; the expenditure on the investment would just offset the proceeds from the loan. If earnings on the investment differed from the repayment of debt, corporate cash flow and tax liabilities would be affected.

The second element of the tax on corporations would be a withholding tax on all distributions from corporations to both individuals and other corporations not subject to U.S. taxation. This tax would apply to dividends, interest, rents, royalties, and any other cash distribution. Exemptions from such withholding would be granted for payments into qualified accounts of U.S. taxpayers, but this withholding tax would be final for taxpayers not subject to U.S. taxation. However, the international trade difficulties raised by any switch to a consumption base should be remembered: For example, U.S. tax treaties are based on an income tax system, and they would have to be renegotiated. Although the problem is not insurmountable (witness the European experience with VAT), the effects of such a withholding tax remain a serious consideration.

Rate Structure and Progressivity

By definition, a consumption base is narrower than a comprehensive-income base (it reduces that base by net saving); in order to capture the same amount of revenues as under a comprehensive-income base, the rate structure must, of necessity, be higher. Certainly, this would be true if the consumption tax was meeting its major planned purpose of increasing the base of net savings in this country. Recognizing the above, taxpayers would not find the same drop in marginal rates under a consumption-tax base as they would under a comprehensive-income tax base. For example, the Treasury proposals would provide a top income-tax rate of 35 percent on individuals, using a tax base that would be more of a comprehensive-income model. Those rates cannot be maintained under a consumption-tax approach; likewise, the rates under a consumption tax would not need to be maintained under a comprehensive-income tax.

The potential for substantial rate reduction represents one of the most important arguments for the comprehensive-income tax. For example, under the Treasury approach, each additional dollar of saving or investment income would be subject to tax at no more than 35 percent — a powerful saving incentive compared with the present system. Consumption-tax proponents, on the other hand, would argue that under *their* proposals each additional dollar of savings or investment income would be subject to a zero rate tax, at least until withdrawn for consumption.

While a comprehensive-consumption tax must, by definition, have a higher rate structure than a comprehensive-income tax, it need not be set at higher rates than the present, noncomprehensive income tax. Professor David Bradford a few years ago updated the *Blueprints* rates structure (to which he had made major contributions as a leader of the project). This rate structure was required to yield approximately the same distribution of tax burdens as under 1976 tax law (when there was a top 70 percent tax on unearned income). Adjusting for inflation from 1976 to 1984, Professor Bradford found that, using a comprehensive-income tax base, exemptions would be about $3,000 per return, plus $1,900 for each taxpayer and dependent. For the model consumption-tax base, exemptions would be about $2,800 per return, plus $1,500 per taxpayer and dependent. More importantly, the top marginal rate for the *Blueprints* comprehensive-income tax model would be 38 percent —not reached until a level of $75,300 of income was attained. The consumption tax, on the other hand, would have a top bracket of only 40 percent, but would be reached at $56,400 of taxable cash flow. This can be contrasted with the post-1983 system where the top rate (joint returns) is 50 percent, but it is not reached until taxable income exceeds $162,400.[54]

While implicit in what has gone before, it should be explicitly noted that the concept of a progressive tax system is as applicable to a consumption tax as to an income tax. The degree of progressivity under a consumption system is basically a matter of how pro-savings the system should be. Given the same base, progressive rates are more pro-savings because they discourage additional consumption.

There has been criticism of consumption-tax systems on the grounds that the tax is, by nature, regressive. Whether this criticism arises because of a common perception of a tax on consumption as being, essentially, a sales tax or a value-added tax is not clear; nonetheless, there is no reason why a consumption tax cannot be as progressive as budgetary or fairness considerations dictate. Granted, progressivity brings complexity, insofar as current collection of tax is concerned. As a practical matter, those complexities are certainly no greater than under an income tax model, and a combination of estimated taxes and withholding should continue to satisfy Treasury's need for current funds.

Wealth Accumulation

A tax system that includes the return on labor (wages) in the base, that permits a deduction for amounts allocated to investment, that allows returns on that investment to accumulate tax free (through the qualified-account concept), and that does away with the tax on corporate earnings is bound to be perceived by some as being inherently unfair, placing a disproportionate burden on the wage earner. Wealth seems to be concentrated in a relatively small number of families; consequently, the ability of that fortunate minority group to take particular advantage will undoubtedly be propounded as an important reason not to enact the new system.

There is merit to this criticism, though there are also arguments to the contrary. For any specific individual, there are two major sources of wealth accumulation: The first is his or her own earnings, and it is clear that these would be included in the tax base; second, however, is the transfer of assets from others, such as through gifts or inheritance. These transfers would also be included in the consumption-tax base, at the same progressive rates as return on labor. Obviously, such transfers would provide their own incentives for placing substantial transferred assets into a qualified account to obtain a current deduction from the base, but to the extent so allocated, the assets are not available for consumption.

Further, notions of fairness may be addressed through the progressive-rate structure applied to the consumption-tax base. Obviously, such a definition of fairness will be in the eye of the beholder; and it is bound, therefore, to flow largely from fiscal and political considerations. Under the present system, the concept of horizontal equity holds that people who are making the same income should pay the same tax. Such a concept would be irrelevant (or at least unmeasurable) if a consumption-tax approach were to be adopted. People whose tradition and heritage have tended to equate tax paid against the income received with the very concept of fairness may find the new definition of horizontal equity — one in which people who consume equally should pay the same tax — to be like playing with new rules whose implications are not understood. Thus, the political push for strongly progressive rates is likely to become even more severe under a consumption-tax approach than has been the case heretofore.

Even if all amounts removed for consumption become subject to tax, the act of permitting invested amounts to build up tax free will certainly make it easier to accumulate wealth than it would be under an income tax system. Since those who come into the system with substantial wealth (including inherited wealth set aside in a qualified account) will be able to add to that wealth free of tax, the concentration problem will be a real one. "The wealthy do not pay their fair share of taxes" is a comment often heard under our present system (though invariably without a definition of what "their fair share" is). In the absence of other provisions, that perception is bound to increase, over a period of time, if the tax system is operating with a consumption tax.

Thus, the need for significant progressivity in a consumed-income tax system is apparent. Further, many proponents of a consumption-tax system (including former Treasury Secretary Simon) recognize the likely need for a gift- or inheritance-tax structure that would be made applicable to the most wealthy to serve the social goal of preventing undue wealth from accumulating in so few hands.[55]

Transition Issues

It is in the transition to a true consumption-tax system that many severe problems arise.

Obviously, a tax system based on income, though more broadly defined and with additional savings incentives, retains the basic political concepts under which the United States has been operating for over half a century. However, even if consumption is now defined as income less net savings, the shift from an income base to a consumption base would be a difficult one.

In simple terms, a consumption system rewards the saver and penalizes the consumer, while an income tax system penalizes the saver and takes little account of consumption. Thus, individuals today who have accumulated assets over a lifetime of labor — particularly if the accumulation has been with a mind to later consumption — have paid income tax both on the return for their labor (wages) and on the return to the after-tax funds invested (dividends, interest, and so forth). Feldstein puts it this way: "[I]ndividuals who have accumulated savings out of after-tax income should not be subject to a new round of taxes when those savings are consumed."[56]

Consider, for example, a wage earner who has built a moderate stock portfolio with after-tax earnings and the reinvestment of after-tax dividends. If the tax system changed overnight to a cash-flow tax, the entire proceeds from the sale would again be subject to tax when removed for consumption. On the other hand, should transition rules designate those assets as tax prepaid, then appreciation on them would escape tax altogether, even though the assets will ultimately be used for consumption. Likewise, income on wealth accumulated prior to adoption of the new system would also escape taxation in any form if the underlying assets were designated as prepaid.

Retired persons, or those close to retirement, would be especially hard hit by the immediate adoption of a consumption tax where assets were considered part of a qualified account. Very young adults just entering the labor force (particularly those with no inherited nest egg) also would be disadvantaged: They are heavy consumers in those early years, with little opportunity for saving. On the other hand, those who have over generations successfully accumulated disproportionate amounts of wealth would be particularly advantaged by immediate adoption of a consumption-tax system treating all assets as prepaid.

Younger families would also be hard hit by the immediate adoption of a consumption tax. For example, a major consumer purchase like a home that is taxed as consumption may cause an enormous redistribution of wealth away from homeowners. Such a change may increase the price of property beyond the financial means of many families. As some in the real estate industry maintain, a consumption tax applied to the purchase of a home would clearly have "a negative impact on the homeownership rate and economic growth."[57]

Obviously, there are important political factors to consider also. The consumed-income tax, although perhaps attractive because it is new, is not well understood. The definition of "necessary expenditures" alone would become a highly charged issue, subject to extensive lobbying.

The state tax systems, as a matter of survival, may be forced to adopt a consumption tax. First, there may be an impact on state and local revenues because state income tax is linked to the federal system. Second, there may be massive compliance problems; taxpayers would continue maintaining certain accounts for calculating state income tax plus the new records necessary for the federal consumed-income tax. In the final analysis, the primary defect of a consumed-income tax is the one shared with the personal income tax: Both require a high degree of voluntary compliance to maintain their effectiveness.

Although transition problems would be great, in the context of this study the consumption tax has many advantages. The main advantage is that it may well promote savings by discouraging consumption. The virtue of this is stressed in the following quote from the Tax Foundation: "John Stuart Mill said the only 'perfectly unexceptionable and just principle of income tax' is to 'exempt all savings.' He believed the resultant savings would stimulate investment in wealth-producing equipment and facilities, thus promoting the best interests of all."[58]

The consumption tax would remove distortions between present and future consumption because the rate on all savings would be zero. If corporate taxes were eliminated in conjunction with the consumption tax, distortions among business investments would also be removed. The consumption tax eliminates double taxation of savings — one of the major complaints about the current system.

However, a consumption tax that was revenue neutral (as compared with an income tax) would require higher tax rates than those on an income base.[59] By definition, consumption is smaller than income. Although taxing consumption would eliminate the distortion between present and future consumption, the higher tax rates increase the distortion between present consumption and leisure choices.

As discussed earlier, a common view, expressed here by the *1984 Treasury Report,* is that aggregate savings under a consumption tax will increase because the incentive for saving — which then would be exempt — would increase: "However, because the net return to saving would be higher, any particular goal for future consumption could be attained with less current saving; this would reduce the need to save."[60] This income effect makes an individual richer, possibly inducing that person to consume more in the present, thus offsetting any effect from the substitution of savings for present consumption.[61]

Many writers suggest that consumption is a better measure than income is of the ability to pay tax. Their argument is that lifetime income is the appropriate base for taxation, and that annual consumption is more stable and hence a better proxy for average lifetime income than annual income.[62] This lifetime perspective allows an equal treatment of taxpayers with the same endowments (or present value of lifetime incomes).[63] Equality would then exist in the sense that the tax would be neutral to when, during a lifetime, one consumed wealth. Now the income tax penalizes those who want to save for future consumption.[64]

The consumption tax can resolve many administrative problems found in the current system (though, as discussed, it would create its own set). The tax would eliminate the need to account for depreciation and inventories as well as the problem of defining capital income, which is heightened by inflation. There would be no need to index for inflation at all because expenditures would reflect current prices. Unrealized income would receive no advantage as compared with realized capital gains because both would be taxed only when withdrawn for consumption.[65]

Finally, the present U.S. tax system is not a pure income tax system, but it does contain various elements of a consumption tax — that is, deductions for retirement savings, lack of imputed taxable income from certain savings vehicles such as life insurance, and so forth. Further, since the U.S. system starts with income in defining consumption, Americans are used to working with that concept (though it is imperfectly defined from a consumption-tax point of view). As pointed out by Harvey Galper of the Brookings Institution (and Associate Director of the Office of Tax Analysis, Treasury Department, at the time the *Blueprints* study was undertaken), the first steps toward a consumption-tax model can be taken in the context of our present tax system; to the extent they involved scaling back current income tax deductions, these steps can also serve to satisfy short-term revenue requirements imposed by congressional budget committees.

Examples of changes that would begin a trend from an income- to a consumption-based system include the following: treatment of specific items of untaxed compensation, deductibility of particular types of interest, deductibility of state sales taxes and charitable contributions for nonitemizers, or readdressing the unified credit levels and rate levels at which the estate and gift tax structure reductions should halt.

Chapter 5

TRANSACTIONAL CONSUMPTION TAXES: VALUE-ADDED AND RETAIL SALES TAX

This chapter discusses two variations of transactional consumption taxes: the value-added tax (VAT) and the retail sales tax. A VAT and retail sales tax differ significantly only in the ways they are administered; consequently, no question exists about the effects of the retail sales tax that would not apply equally to the value-added tax.[66] Thus, the discussion centers on the VAT — its operation, its advantages and disadvantages, and the comparison with other taxes. The logical conclusion of such a discussion is a consideration of how a national retail-sales tax differs from a VAT.

What is VAT?

VAT is an indirect tax — that is, a tax levied directly only on goods and services and, therefore, only indirectly on persons. Indirect taxes include retail sales taxes, excise taxes, and import duties (as compared with direct taxes, examples of which include individual or corporate income taxes and gift or inheritance taxes).

Theoretically, VAT is a tax on the value added to goods or services by each separate processor in the production and distribution chain. In actuality, it is a tax on the increase in the sales price of the goods or services as they pass through that chain. Ultimately, however, it is a tax on consumption—on the amount spent for the product by the final consumer. The consumer ultimately bears the burden of the tax, even though the actual payer of the bulk of the tax is the manufacturer or processor.

A tax on consumption, incurred only when money is spent, puts a premium on savings as contrasted with the bias against savings in an income tax, under which part of the income itself must be paid to the government and cannot be saved. Accordingly, despite its political unpopularity, there are arguments that a VAT may increase the level of private saving and generate a corresponding increase in capital formation and growth.

Types of VAT

At its simplest, under VAT each processor collects a tax on sales of goods or services, deducts the amount of taxes paid, and remits the difference to the government. If the processor pays more tax than is collected, the processor receives a refund. There are three types of VAT, classified according to their treatments of purchases of capital items: gross product, income, and consumption VAT.

Under the gross product VAT, no deduction is allowed for tax paid on capital items; the payer can only recover through an increase in the selling price of goods produced directly or indirectly by the taxed capital item. Under the income type, recovery of the VAT paid would be allowed ratably over the life of the asset; thus, VAT paid on the purchase of a capital item with a five-year life would be one-fifth recovered in the year of purchase and one-fifth in each of the following four years.

Both the gross product and income versions of the VAT penalize capital investment by placing an additional tax burden on capital equipment purchases. The tax would be imposed on the capital good itself and on the output produced by the capital good. In contrast, a consumption-type VAT would not affect the methods of production because substituting capital for labor (or vice versa) would not alter a firm's total taxes; it also would not influence the decision to save or consume. The consumption type will be the only one considered in detail here.[67]

Methods of Determining the VAT Base

There are three generally recognized methods of determining the tax base to which a VAT rate may be applied: (1) under the *addition* method, the firm totals its payments for labor and capital, subtracts from this sum its payments to other businesses for production facilities, and applies the tax rate to the resulting amount; (2) under the *subtraction* method, the firm subtracts all its payments to other businesses from gross sales and receipts and applies the applicable VAT rate to the remainder; or (3) under the *invoice* (or credit) method, the firm multiplies its total sales by the applicable tax rate and subtracts from the resulting tax liability all of the VAT paid to suppliers, as shown by the invoices for purchases from other firms. This is equivalent to getting a tax credit for the VAT the firm has paid against its own VAT liability. These three alternatives are illustrated by the example in table 7 on page 31, which is taken directly from the 1984 Treasury proposals. That example assumes an economy with only three firms — one each in manufacturing, wholesaling, and retailing. The manufacturing sector sells all of its output to the wholesale sector; the wholesale sector buys only from the manufacturing sector and sells all of its output to the retail sector. The rate of tax is 10 percent.

So that the three methods of determining a VAT liability may be compared with the more familiar income-tax-base calculation, a highly simplified profit and loss statement for income tax purposes appears as exhibit 1 in Appendix A. For purposes of this exhibit, the beginning and ending inventory is limited to purchased material, and no attempt is made to assign overhead costs to inventory. (This is because VAT theoretically depends on the kinds of expenditures made, rather than on how they may be treated for financial or income tax accounting purposes.) The various accounts reflected are identified according to whether they are used in determining a VAT liability under the invoice, the subtraction, or the addition method.

These illustrations are included here primarily for the sake of being complete. It is important to demonstrate the various methods of collection and to point out that VAT can be levied as a direct tax, but consideration of VAT has almost always been in the context of an indirect tax. As such, the invoice method has, in practice, appeared to be the most appropriate means of determining liability. This is the method employed by the members of the European Economic Community (EEC) and most other countries that have adopted VAT.

To elaborate on the invoice method, the tax-collecting chain begins with the sale of raw materials on which VAT is charged by the seller at a fixed rate and remitted by that seller to the government. The purchasing manufacturer thereafter charges VAT on the sale of the finished or semifinished product to another manufacturer or a distributor. However, instead of remitting the total collection to the government, the manufacturer is entitled to reimbursement for the VAT paid on the purchase of the raw material. Only the difference, or the tax on the "value added" by the manufacturer, is paid to the government. The process is repeated by the second manufacturer or the distributor when, in turn, a sale is made in the business cycle. VAT is charged on the total sales price, the seller self-reimburses from the proceeds, and only the difference is remitted to the government. When a final sale is made — usually by a retailer to the ultimate consumer — the tax may or may not be shown separately, for at this point the chain comes to an end.

While the retailer is entitled to a reimbursement for VAT previously paid, the purchaser, who in the capacity as the consumer of the item acquired, is not in the business of selling goods or services, must bear the full tax cost. Thus, the VAT cost is passed through each business operation until it is finally paid in the purchase price by the retail consumer. VAT is intended to be a tax passed on to the ultimate consumer, although the effect of the VAT rate on the price the market will bear may, in some cases, force a seller to reduce the profit margin. Thus, the producer may be forced to absorb some of the VAT.

Table 7

Comparison of Three Methods of Calculating Value-Added Tax Liability (10-percent value-added tax)

	STAGE OF PRODUCTION			
	Firm A Manufacturer	*Firm B Wholesaler*	*Firm C Retailer*	*Total Economy*
1. ADDITION METHOD				
Factor payments plus net profit				
Wages	$150	$300	$ 200	$ 650
Rent	50	100	20	170
Interest	25	75	20	120
Profit	25	25	10	60
Total	250	500	250	1,000
Value-added tax	$ 25	$ 50	$ 25	$ 100
2. SUBTRACTION METHOD				
Sales	$350	$850	$1,100	$2,300
Purchases	(100)	(350)	(850)	(1,300)
Value added (sales minus purchases)	250	500	250	1,000
Value-added tax	$ 25	$ 50	$ 25	$ 100
3. CREDIT METHOD				
Sales	$350	$850	$1,100	$2,300
Tax on sales	35	85	110	230
Purchases	100	350	850	1,300
Tax on purchases	(10)	(35)	(85)	(130)
Value-added tax (tax on sales less tax on purchases)	$ 25	$ 50	$ 25	$ 100

Source: U.S. Treasury Department, *Tax Reform for Fairness, Simplicity, and Economic Growth* (Washington, D.C.: USTD, November 1984), 3:9.

It should be noted that the pass-through of the VAT cost applies to all purchases made by a business, whether of goods or services. If an enterprise pays VAT on an electrical bill, on stationery supplies, or on legal and accounting fees, the enterprise may recover the amount on the subsequent collections of VAT made on its own billings. The system, therefore, depends heavily on adequate invoicing, which sets out VAT as a separate item until the final sale for ostensibly private consumption.

VAT Rates

The fewer the exceptions or modifications, the more easily the system operates. Nevertheless, all the systems presently operating in Europe do grant relief to certain types of sales, generally in one of three possible forms.

1. The sale is taxed at a reduced rate (multiple-rate system).
2. The sale is exempt.
3. The taxable base is reduced.

Multiple Rates

Permitting two or more rates of VAT within a single production chain may or may not decrease the total tax paid. If there is a standard rate of 3 percent and a reduced rate of 1 percent, the total tax paid does not change as long as the standard rate is applied at the end of the chain. For instance, if an item is purchased for $100 in a transaction to which the reduced rate (1 percent) applies, one dollar of VAT is collected and remitted. If the item is thereafter sold for $400 in a transaction in which a standard rate (3 percent) applies, the normal twelve dollars is collected and the seller self-reimburses for the one dollar previously paid, remitting eleven dollars to the government. The effect in such a case is merely to shift forward the total collection of tax. If, however, the situation is reversed and the normal rate is applied to the $100 purchase (meaning that a VAT of three dollars is paid upon acquisition), and the reduced rate is applied to the $400 sale (meaning that only four dollars in VAT is collected upon the second transaction), then total VAT collected drops from twelve to four dollars. Thus, a reduced rate at the end of a chain will also reduce total VAT collected. (See Appendix A, exhibits 2 and 3.)

Exemptions

The system can operate more easily if exemptions are kept to a minimum, but in most countries using VAT many applications are placed outside the system. These include the following businesses and transactions: (1) very small, probably retail, enterprises with marginal annual turnovers; (2) financial transactions (life insurance, banking, security purchases, and sales); (3) medical and educational services; (4) charitable activities; (5) newspaper, periodical, and book sales; and (6) sales of agricultural products and food. While these enterprises are required to pay VAT on most of their purchases, they do not charge the tax on their sales. The primary result of the exemption, then, is that they cannot recoup VAT paid through charges for the tax on sales; VAT paid becomes a cost of doing business, just like any other cost. Questions of pricing strategy and competition about how (or if) this cost is passed to the consumer then must be answered by the entity's management.

If the exempt business sells mostly at retail, the inability to recover VAT may not be a disadvantage, because VAT is also not charged on the "value added" by the exempt person or entity. When profit margins are sufficiently high, an exemption can even prove to be a competitive advantage. While a small exempt retailer may purchase an item for $100 and pay the same 3 percent VAT as a larger taxable retailer, the small retailer's price to a customer need not include VAT and thus can be less than the amount charged by the larger retailer. For instance, if the larger retailer's resale price is $200, the charge is $206 (assuming a 3-

percent VAT) to recover the three dollars paid earlier and remit the three dollars levied on profit to the government. The smaller exempt retailer can charge something less and perhaps still make the same profit (depending on operating costs) with a price that covers VAT costs on purchases but not VAT on the resale.

In some cases, activities that are normally exempt may wish to have the option of electing to be covered, especially if small profit margins do not give them any real advantage over their larger taxable competitors. Such elections are permitted for some activities in a number of European systems. Other activities, like farming, may be granted a reduced rate that does not affect prices as substantially as other rates but does permit the activity to recover VAT paid on purchases — if not from VAT collected on sales, then from the government by way of refunds. Such variants complicate the system, of course, but seem to be widespread.

Businesses that are exempt on certain lines of activity but taxable on others also present special problems, requiring purchases to be prorated between exempt and taxable sales so that VAT recovery is limited to those purchases that can be related to taxable sales.

When a person or entity is exempt and makes a sale to a taxable person (that is, a sale that is not at retail), the taxable purchaser, not being charged (directly, at least) for VAT, will not be reimbursed for that cost upon resale. Thus, if the price charged for an item by an exempt seller is $100, which in fact covered two dollars of VAT paid earlier in the chain, and the taxable purchaser in turn sold the item for $200 in a sale to which a 3-percent VAT applies, the latter collects six dollars and remits the entire amount to the government. As a result, total VAT paid is eight rather than six dollars — the total tax paid in the normal case.

An exempt stage in the course of a business chain may have the effect, therefore, of increasing the total tax paid because the taxable purchaser from an exempt seller is not entitled to reimbursement for VAT that may have been paid on the item before it was acquired. That is, if an exempt seller is selling to the ultimate consumer, that seller may have a competitive advantage over a nonexempt seller of the same product; conversely, if that seller is selling to a nonexempt reseller who is not the ultimate consumer, the exempt seller suffers a competitive disadvantage. (See Appendix A, exhibit 4.)

Zero Rate

In some cases, the government may allow a refund or credit for prior VAT paid, even though a subsequent sale is exempt. Use of a zero rate is one method of overcoming the administrative problems involved in refunding or crediting taxes paid on purchases when the subsequent sale is exempt. For example, if export sales are exempted, that is of no great benefit to the exporter unless the taxes paid on purchases attributable to the export can be recovered. Rather than having two categories of exempt sales — tax recoverable and tax nonrecoverable — the zero rating (in essence, an exempt, tax-recoverable sale) has been devised. This way, all truly exempt sales will be in the nonrecoverable category.

For example, the 1984 Treasury study uses the example of an urban transit service to highlight the difference between zero-rating and exemption.[68] If urban transit service was zero-rated, then no tax would be charged on the transit service fares. The transit system would receive credit or refund for the VAT paid on its purchases of equipment, motor fuel, supplies, electricity, and any other business-use items. If transit service is exempt, however, the system providing the service will not apply tax on the fares received, and it will not receive a credit or refund for tax paid on its various purchases.

Refunds and Credits

If a business is just commencing, or if it has heavy export or other exempt or zero-rated sales, it is possible for its collections of VAT on sales to be materially less than it paid on purchases. In cases of this type, the government may refund the difference on a monthly or quarterly basis, or it may require the entity to carry forward the unreimbursed VAT against sales of later periods. In such a case, if sales by the entity do not incur sufficient VAT to offset VAT paid on purchases both currently and on a carryover basis, the unrecovered tax obviously becomes a cost to the enterprise. Generally speaking, the refund system is preferred to that requiring an enterprise to recover its VAT on a credit basis over an extended period of time.

Capital Goods

One interesting feature of VAT as it is usually applied is that purchases of capital goods are included within the system. Thus, manufacturers' purchases of machinery and equipment would generally be subject to the normal rate, which would be recovered currently by VAT collected on sales of manufactured goods. The consumption-type VAT is the European norm, permitting full current recovery of VAT on capital goods; however, some authorities argue that VAT on such items should not be recovered at all (gross product system) or that VAT should be recovered only over the life of the asset on an annual pro rata basis (income system).[69] These last two systems of VAT have not been generally accepted, but most countries that have introduced VAT have provided transitional rules with respect to VAT paid on capital goods. Thus, in the first year of the new VAT system, only a partial recovery of VAT paid on capital goods is permitted; in the second year, an additional amount is allowed, and so forth, until all VAT paid on such items is reimbursed. This stepped phase-in to a full-consumption VAT can be crucial: Allowing full recovery of the tax immediately can seriously affect the capital goods market where VAT replaced a local sales tax that was not recoverable.

The impact on tax revenues is another reason for going to a full-consumption system gradually. Depending on the structure, under a sales tax the tax on capital goods may not be recovered, but under a VAT all of it would be recovered in the year of sale.[70] The VAT on the sales resulting from use of the capital equipment, however, would be spread over many years.

Advantages of VAT

In concept, the tax itself has certain advantages and disadvantages. As in other areas of tax design, however, there are few bright-line pluses and minuses. Thus, what appears an advantage to proponents of a VAT may be a distinct disadvantage to opponents, and the following analysis of the pros and cons inevitably contains some duplication.

The proponents of a VAT frequently see its adoption as a means of encouraging savings and of raising the billions needed by the federal government to alleviate growing budget deficits. In doing so they often cite the following main advantages of a VAT.

Large Potential for Revenue

That a federal VAT has a tremendous potential for revenue is obvious. Transactional consumption provides a much greater base than any other federal tax system presently employed; its value base can be as large as the gross national product. The Treasury estimates — even allowing for exemptions for vital necessities and for certain industries and groups — that the projected 1988 VAT base would be about $2.4 trillion. Each percentage point of a VAT levied on this total would yield about $24 billion.[71]

Encouragement of Savings

VAT, being a consumption-based tax, would probably be perceived by most as being strongly pro-savings rather than being pro-consumption. Some commentators, however, have argued that VAT is relatively neutral in this regard. Since a VAT would probably be imposed on virtually all goods and services (whether oriented toward consumption or saving), the VAT should raise the cost of saving in the same proportion that it raises the cost of consumption. In addition, a "consumption VAT," in which the cost of capital outlays is currently deducted from the tax base, would be tax-neutral in capital formation.

Thus, it is argued that VAT is essentially neutral toward the saving/consumption choice.[72] However, since the present U.S. system has an apparently negative effect on saving, the VAT is relatively pro-savings, thereby creating a salutary effect that would make greater investment and a higher rate of economic growth possible.[73] Nevertheless, the degree that saving would increase by substituting VAT for part of the income taxes is difficult to predict because that degree depends crucially on the elasticity of saving with respect to the interest rate, a figure of debate among economists. Charles McLure, for one, feels positive: "If savings elasticities are near the high end of the range generally agreed to be reasonable, a tax substitution of this type could significantly increase saving."[74]

Neutrality of Application

VAT, being based on the selling price of products, does not favor capital-intensive over labor-intensive industries. The use of equity financing and debt financing does not affect the tax except as their elements are passed on in price. Present income-tax incentives would be nullified. The form of business organization does not affect the tax.

Encouragement of Efficient Resource Allocation

Some observers argue that business would allocate resources more efficiently if it were freed from the income tax system's inducement for wasteful spending. A VAT does not tax the business as such, but only the end product or service; consequently, all advantage under a VAT lies in reducing the total costs of the business, as reflected in the ultimate selling price. Thus, the imposition of a VAT can well lead to capital investment (for example, plant modernization) and consequently lower unit costs.

More Stable Revenues

In addition to the large potential for revenues, VAT is independent of profits and so it would also avoid the fluctuations of the present U.S. tax system, resulting in a more stable, predictable basis of federal receipts.

Ease of Administration

A VAT, argue proponents, is relatively easy to administer. The self-policing aspects of the tax have proved to be sound in application. In an ideal VAT system with a single rate and few exemptions, the accounting procedures would be relatively simple.

Incentive for Exports

A major reason for the institution of the VAT in Europe was the desire to harmonize taxes on exports within the EEC. The use of exemptions or a zero rate on exports removes the tax inhibitions and inequities on trade and ensures a uniform tax burden in each jurisdiction. This same rationale extends beyond the EEC and encompasses all countries that are signatories of the General Agreement on Tariffs and Trade (GATT). Under GATT, all indirect taxes on export transactions may be rebated and are not treated as export subsidies, which are prohibited.

Export products of a country that relies heavily on indirect taxes carry less of the overall tax burden and may have a competitive trade advantage. The imposition of a VAT does not itself create this advantage; but to the extent that it substitutes for another tax, such as an income tax not rebatable under GATT, VAT provides an incentive to export. (See Appendix A, exhibit 5.)

Since VAT is "GATT-legal," it would also carry the advantage of an approved (by treaty) export subsidy. The international difficulties posed to the United States from such export incentives as Domestic International Sales Corporations (DISCs) or Foreign Sales Corporations (FSCs)would not exist.

Recapture of the Underground Economy

Many people in the public and private sectors are convinced that the present income tax system encourages taxpayers to avoid taxes by operating outside it — that is, by creating an "underground economy."[75] Proponents of a VAT suggest that one of its major advantages would be to reintroduce much of that underground economy into the federal tax system. VAT can take a positive step in that direction, although underground activities such as bartering can still continue. The experience of foreign countries indicates that the significance of increased participation is somewhat overstated (for example, bartering and "moonlighting" transactions still go unreported).

Disadvantages of VAT

The opponents of a federal VAT believe the present U.S. tax system works remarkably well and would work even better if loopholes were closed, inequities were removed, and the base was broadened. On the other hand, opponents of VAT emphasize the following major deficiencies.

Too Much of a Revenue Potential

Fiscal 1984 corporate tax receipts approximated $56.9 billion.[76] Based on Treasury estimates of $24 billion per percentage point of VAT imposed, the corporate tax system can be replaced with a VAT of 2.4 percent. Even adding to this figure the fiscal 1984 estimated individual tax receipts of $296.2 billion, both individual and corporate totals can be raised with a 14.7 percent VAT.

Perhaps the most illuminating caution about the VAT was made by a long-time advocate of it, Dan Throop Smith: "If a VAT leads to excessive government spending which would not otherwise occur, the great revenue potential of VAT may be the best argument against it."[77]

Lack of Counter-Cyclical Balance

The income tax is said to be a built-in stabilizer for counter-cyclical fiscal policy. In boom periods it drains off more revenue from the private sector, dampening an overheated economy; on the downswing, it has the reverse effect. The relatively inelastic VAT lacks this counter-cyclical aspect; and while it would not restrain a boom, it may contribute to the decline in consumption in a recession.

Burden on New or Marginal Enterprises

A VAT would require each business, regardless of its profitability, to include a proportionate share of the federal tax burden in its billings for goods or services. Thus, the new or marginal business may not be able to meet the price competition occasioned by a reduction of income taxes on profitable business and a replacement of tax through a VAT on all business.

Inflationary Effect on Prices

A VAT is inherently inflationary. It is an additional element of cost to be passed on to the consumer, and it thus increases the ultimate selling price. This cost-push principle makes the imposition of a VAT not without risk. According to some economists, the chain reaction, resulting from imposition of VAT, creates the possibility of an inflationary spiral.[78]

On the other hand, the Treasury proposals note that the experience of countries with a VAT confirms the view that it may generate a one-shot increase in the price level but *not* an annual inflationary spiral: "There may be some secondary price increases because of wage payments and other business contracts that are indexed to the general price level, but these would be modest by comparison with the initial increase."[79] The 1981 International Monetary Fund study relied on by the Treasury noted that in twenty-one of the thirty-one countries analyzed, the introduction of a VAT had no major impact on the price level. Out of the remaining ten, only one (Norway) had a rate of increase in the price level not explained by other economic factors. The IMF study concluded that the introduction of a VAT was not "inherently" inflationary.[80]

Also, certain factors can mitigate the inflationary impact of a VAT. If the tax is a replacement for other taxes, the inflationary aspects may be minimal. This would also be true if governmental spending policy reduces the need for personal outlays, leaving a larger balance for normal consumption or savings. Also, a low rate of VAT would produce relatively little inflationary pressure; on the other hand, if the tax is substantial, both savings and consumption would drop (unless taxpayers, through increased production, are able to increase their total incomes to compensate for the tax).

Difficulties of Administration

The experience of foreign nations indicates that it is not as easy to administer a VAT as was once assumed. Nations with a VAT continue to have problems with compliance and collection; levels of VAT evasion appear to be comparable with levels of income tax evasion. In fact, some of the administrative problems are similar (for example, the difficulty of separating business from personal expenditures). The Treasury estimates that when fully phased in, the administration of a VAT would cost about $700 million per year and necessitate the hiring of about 20,000 employees over three years, in addition to the staff presently needed to administer the income tax.[81]

If a VAT or a federal retail sales tax were combined with the various state sales taxes now in existence, they could be administered through a single authority, which would increase uniformity and decrease administrative problems.[82] Of course, the states would have to agree to become part of such a national system, and such agreement would be far from certain. To date, no state has taken advantage of the opportunity to completely tie its income tax system to the federal income tax.

Lack of Incentive for Exports

The export subsidy advantage for VAT has been challenged repeatedly. VAT is not directly a cost item to a producer, who obtains no direct benefits from its remission. It is true, however, that a national VAT is not included in a foreign sales price, thus permitting an exporter to charge what may be considered a more competitive price abroad. To this extent, exempting export sales from VAT can improve an exporter's ability to compete in a foreign market.

On the other hand, if the country of destination imposes a VAT, any advantage attributable to tax relief is obviously neutralized. Imposing a VAT and then remitting it on exports cannot act as a subsidy. However, VAT imposed in lieu of an income tax, or of an income tax increase that would not be rebated, does shift overall tax costs from exported items. In this context, a VAT can be said to favor exports, although it is not an outright incentive.

Regressive Nature of a VAT

As already noted, there is consensus that a relatively low rate of VAT would yield a high total of tax revenue. However, a prime concern is that this burden would be largely shouldered by lower income groups, who tend to consume a higher proportion of their income than the more wealthy. Thus, the tax would likely be regressive.

To counter this argument, some VAT proponents, after giving consideration to the flow of government expenditures generated by a VAT, believe that the real incomes of the low-income groups may even be enhanced. When government expenditures, directly or indirectly, distribute proportionately greater benefits to low-income groups than their aggregate contribution, the tax system employed should be considered progressive. Thus, family allowances, student grants, pensions, medical payments, and similar social benefits — if liberalized through VAT financing — can free individuals from having to save for these important contingencies, or at least having to subsidize their costs.

Furthermore, it has been suggested that regressiveness can be overcome by credits or refunds, although no country has employed such a system. On the other hand, exemptions for food, clothing, medicine, and other necessities are common under the Western European VAT systems; but these exemptions extend benefits beyond those needing relief and, like credits or refunds, add complexity.

Harming State and Local Revenue Sources

An important aspect of introducing a federal VAT or retail sales tax would be the effect on state retail-sales-tax systems. The 1984 Treasury study, however, notes the following: "While the Federal government should be sensitive to the impact a national sales or value added tax would have on state and local governments, it is not clear that this should preclude Federal adoption of such a tax."[83]

Presumably, VAT can be administered as a separate system more easily than the multitude of state retail-sales-tax systems can, but it is also clear that the existence of two such tax systems side by side is undesirable. The Treasury states: "[I]t would be administratively difficult to piggyback state retail sales taxes on a Federal value-added tax."[84] Ideally, the federal government can collect all VAT or retail sales taxes and remit a predetermined portion to each state. In fact, a VAT system might permit the federal government to remit revenue to the states where value was in fact added, rather than simply to the states where the final retail sale took place, as would be the case under the traditional sales tax setup. Obviously, such a single system would require a nationwide rate if either a VAT system or a federal retail-sales-tax system was to be adopted.[85] Although this appears to encroach upon the right of the states to determine tax rates locally, the provision for revenue sharing can have a positive long-term effect. The likely approach, then, would be to harmonize transaction taxes as levied by the various states and thus to remove some of the inequities existing among the various states that continue to affect interstate commerce. The point would doubtless be made that if Europe can harmonize its tax systems within the EEC, the United States should be able to accomplish the same sort of federal-state harmonization, with considerable overall benefit to business. As a politically practical matter, however, it may never be possible to obtain the acceptance of such an arrangement by fifty separate states.

Comparison of VAT With Other Taxes

If the U.S. government were to impose a VAT, the tax would probably be as a partial substitute for other federal taxes, specifically the corporate or individual income tax. Thus VAT may be used as a replacement for or as a supplement to federal taxes presently in place.

VAT Compared With the Federal Corporate Income Tax

Economists disagree about the extent to which the corporate income tax is absorbed by business, reducing the after-tax rate of return on labor and investment, or is merely passed on to the consumer in the form of higher prices. This uncertainty makes it very difficult to compare the effects of the corporate income tax with those of a VAT, which would clearly be reflected in prices. Although it is difficult to be certain of the extent of the difference, the comparatively low rate of VAT (contrasted with the corporate income tax rate) provides some likelihood that VAT would be passed on to the consumer to a greater extent than present income taxes on business are now.

If this were the case, such an effect would have both advantages and disadvantages. On the one hand, substitution of a VAT for income taxes would increase the after-tax rate of return, thereby stimulating savings and investments. On the other hand, the VAT would be more regressive than the corporate income tax, and the increase in consumer prices would have some inflationary effect.

Another point of comparison involves the issue of neutrality. Some economists consider VAT a more neutral tax than income tax.[86] There are, however, problems with this position. In recognition of political realities, Congress would probably produce a U.S. VAT system with exemptions and other complexities, or gradually add such complexities over time, thereby eliminating much of the neutrality of the tax. Insofar as the VAT does remain neutral, it would be so in the sense of applying equally to all business enterprises. The present tax system has less effect on small or marginally profitable companies because of differences in the tax rates. The introduction of a VAT may increase the burden on smaller and marginal firms — an effect that may even hasten the collapse of marginally profitable enterprises. Thus, in comparison with today's corporate system, the VAT would not be completely neutral; compared with the present income tax, it would result in a bias favoring larger, more profitable businesses.

VAT Compared With the Federal Individual Income Tax

Of all taxes levied by the federal government, the individual income tax yields the greatest revenue. Its progressivity and successful self-assessment procedure have been matters of pride to many Americans; the likelihood of it ever being completely replaced by a VAT is practically nil. Nor is it likely that VAT would be used to reduce the personal income tax rates because of its apparently regressive nature, certainly when compared with the progressive individual-income-tax rate structure. Although VAT may be made less regressive by special rates, credits, exemptions, and rebates (and probably would *have* to be if it is introduced in the United States), such features would make it more complex administratively.

A VAT used as even a partial substitute for the federal individual-income-tax system appears, therefore, to be politically unlikely. If VAT were to be adopted because of its favorable effects on business, certain features of the present income tax system may then be subject to modification in order to improve the system's progressivity.

Some economists also maintain that high income taxes cause resources to shift outside the economic system. They argue that, as income taxes increase, present consumption replaces saving and leisure time replaces work.[87] Such a shift results in lower production and a lower standard of living. The VAT, on the other hand, would encourge saving and discourage present consumption.

Retail Sales Tax

Forty-five of the states, the District of Columbia, and many local governments have a retail sales tax, a single-stage tax that applies on all sales to final consumers, not just those made by retailers. A retail sales tax is levied on all final or retail sales of goods and services except those that are exempt from tax.[88] Most of the advantages and disadvantages claimed for a VAT would also apply to a retail sales tax, and thus only the major differences are highlighted.

Potential Revenue

A major advantage of a national retail sales tax would be its sizeable potential revenue. For fiscal year 1984, the Congressional Research Service estimates that a retail sales tax would yield between $8.1 billion and $18.2 billion per 1 percent of tax, depending on the comprehensiveness of the sales tax base.[89] Using the Treasury estimates of $3.127 trillion of personal consumption expenditures for 1988, a 1-percent retail sales tax would yield between $10.9 and $24.7 billion, as compared with $24 billion for a 1-percent VAT. (See Appendix B.)

Other Advantages and Disadvantages

Another advantage of the retail sales tax is its relative ease of administration. The retail sales tax is not in theory simpler than a VAT, but it is imposed only on the *last* transaction, thereby reducing administrative costs and the number of businesses required to file returns.

Furthermore, the retail sales tax has the advantage of familiarity; the U.S. public knows how a retail sales tax operates and copes daily with its administrative burdens. A 1983 Gallup Poll survey, contracted by the Advisory Commission on Intergovernmental Relations, asked this question: "If the federal government had to raise taxes substantially, which would be a better way to do it?" The respondents preferred a sales tax with a food exemption by more than a two-to-one margin instead of an increase in the personal income tax.

Table 8

Responses to the Question:
"If the Federal Government Had to Raise Taxes Substantially, Which Would Be the Better Way to Do It?"
(in percentages)

	Increasing Individual Income Taxes	*A New National Sales Tax on All Purchases Other Than Food*	*Don't Know*
Total Public Asked	24	52	25
Male	25	53	22
Female	23	51	27
Northeast	31	40	29
North-Central	21	58	21
South	21	55	24
West	24	52	25
Nonmetro	21	57	22
Metro—50,000 and over			
Fringe	27	50	23
Central city	25	46	30

Source: Advisory Commission on Intergovernmental Relations. *Changing Public Attitudes on Governments and Taxes.* (Washington, D.C.:. ACIR, 1983), 9.

VAT Compared With the Retail Sales Tax

Like a broad-based VAT, a retail sales tax that exempts all production inputs, including capital goods, would be relatively neutral with respect to both consumption and production decisions. Most states do not fully exclude capital equipment and other business purchases from the scope of the retail sales tax, unlike the exclusions under a VAT. Although all states exclude sales for resale, including sales of goods that become physical ingredients or component parts of goods produced by the purchaser, the states have more limited exclusions for fuel, industrial machinery, farm machinery and equipment, office supplies and equipment, and other business purchases not consumed directly in the production process. In practice, most states make no serious effort to exclude all purchases for business purposes from their retail sales taxes. About 20 percent of state retail-sales-tax revenue comes from taxing producers' goods.

A comprehensive federal sales tax would offer the states an opportunity to "piggyback" the state taxes on the federal base. States would enjoy the advantage of the broadly defined federal base, but would be free to set their own state tax rates, depending on state fiscal needs. This would avoid any intergovernmental disputes over the proper amount of sales tax revenue to be shared with the states. Federal-state piggybacking in this area would be easier to apply under a federal retail-sales-tax than under a federal VAT. The Treasury notes: "Either tax, retail sales or value added, would be viewed by state and local government officials as encroaching on the fiscal territory of the states and would be criticized as such, though the value added tax might be more acceptable because of its cosmetic differences."[90]

Since a federal retail sales tax is collected only at the end of a chain of transactions, the probability of successful evasion increases. A VAT is collected at every stage and thus has a self-enforcing aspect lacking in a retail sales tax. The self-enforcing aspects of a VAT, however, appear to be overstated. Many countries find it necessary to employ a comprehensive program of matching the VAT remitted by the seller with claims for credit by the purchaser — a matching program similar to the one currently used in the United States for dividend and interest reporting. Furthermore, with the VAT there is a problem of fraudulent invoices to claim credit for nonexistent purchases.

Several less important differences also exist. A VAT tends to cover the service sector of the economy more broadly than the retail sales tax. A VAT is simpler in operation for commercial customers: It does not require resale certificates or exemption certificates, for example. The VAT is completely rebated on exports, whereas a portion of the retail sales tax (on supplies, for example) may not be rebated. Finally, because retail sales taxes have until now been reserved for state and local jurisdictions, the adoption of a federal retail sales tax may create political problems, but the adoption of a VAT may also avoid some of them.

Chapter 6

CHANGES TO THE CURRENT SYSTEM

Aside from major structural shifts to a comprehensive income tax or a consumption tax (periodic or transactional), a third alternative for improving saving is to make changes to the current tax system that discourage consumption, encourage saving, or do both. This approach is summed up in a sentence by Senator David L. Boren: "Instead of confusing this [savings] issue by injecting a debate about a major shift in the tax structure, an evolutionary change in the present system may well be preferable."[91] Changes fall into several categories. One method would be to add saving incentives to the system; another would be to increase provisions that are already pro-savings. Finally, reducing deductions, exclusions, and so forth, that are anti-savings would encourage saving relatively more than the current system does.

Appendix C includes a list of major revenue items in the present system, and serves as a possible road map to those provisions which, because of the potential dollar effect, can be viewed as a relatively efficient way to provide saving and investment incentives. Because the Congressional Budget Office prepares periodic estimates of the ongoing projected amounts of "tax expenditures," it is possible to be relatively confident about the revenue impact of specific potential changes. That impact is reflected in Appendix C, based on the last such CBO study (issued in October 1983 for the government's fiscal years 1983–1988).

However, changes in the tax system, whose revenue effects have traditionally been measured on a static basis, create serious questions concerning equity, simplicity, and economic side effects. Appendix C presents one set of views about how pro- or anti-savings some of these changes may be, how broadly taxpayers can be affected, and the degree to which administrative or statutory simplicity can be introduced from such changes. These are, however, highly subjective views, any of which may provoke disagreement. (Thus, readers of this study are cordially invited to substitute their own opinions on these subjects and, effectively, produce their own tables as a guide for future changes to our existing income tax system.)

Yet another incentive for saving is a savings tax credit, which would be similar in intention and computation to the investment tax credit, but would be used for personal savings rather than for business investment. Another possibility is to exclude saved income from taxation until consumed; such a provision would effectively move the current system toward a consumed-income tax. Finally, a schedular system may be instituted that would tax saved income at a lower rate than consumed income. All of these proposals certainly would encourage saving more than consumption.

Still another way to encourage saving within the present system would be to increase provisions that are already pro-savings. The accelerated cost recovery system can be further accelerated and investment tax credits increased. Additional incentives can be provided for research and development while rates are reduced further on the first $100,000 of corporate income (or the $100,000-level can be raised).

On the personal side, pro-savings measures may include the provision of added preferential treatment for capital gains through reduction of rates or of holding periods, or of both.

Deductible contributions to IRAs and Keogh plans can be increased, along with interest and dividend exclusions; interest and dividends can even be wholly excluded (full exclusion of dividends would serve to eliminate the problem of double taxation). Reduction or elimination of estate and gift taxes is yet another possibility. Finally, current provisions for indexation can be increased. All these changes would tend to increase personal savings. (Non-supply-side economists would be quick to argue that the increase would come at possibly an unacceptable cost to the federal fisc.)

Finally, deductions, deferrals, and exclusions that produce an anti-savings effect may be reduced or eliminated. Perhaps the most significant item to modify is the personal interest deduction. The interest deduction tends to promote consumption, encouraging the flow of funds into homes and durable goods rather than into financial assets. Furthermore, if the interest deduction is not reduced or eliminated along with other changes, taxpayers may simply borrow to increase their savings and, hence, receive double deductions.

Making changes to the current system is certainly the alternative that is easiest to implement administratively. The Congressional Budget Office takes this position: "The proposals for interest exclusion, reducing the maximum rate on investment income, and disallowing the interest deduction would require little or no change in existing procedures."[92] These proposals would probably succeed in increasing funds available for capital formation, although the extent of such an increase cannot be predicted with certainty. Hence, changing the current system is advantageous mainly because it would encourage current savings and would be relatively easy to accomplish.

As noted previously, if the changes simply involve new saving incentives without a concurrent change in the interest-deduction provisions, taxpayers may simply borrow to invest. The tax system will encourage both borrowing and investing and have little effect on total capital formation.[93] Furthermore, if the incentives are only for certain forms of savings, they may simply shift savings from other instruments to the tax-favored forms. In addition, the raising of exclusions for savings may only help high-bracket taxpayers, who can afford to save more than the current limit.

Although these changes would be easiest to accomplish administratively, the problem of hurting political constituencies would not disappear. *Tax Notes* points out just one example: "The subsidy [the home interest and real estate tax deduction] provides has been widely incorporated into prices and investment decisions throughout the economy and could not be eliminated without causing significant short term losses and economic dislocation."[94] Repealing such deductions would be difficult at best, and without repeal, the creation of an incentive to borrow to invest looms large. Instituting new saving incentives may also be difficult politically because taxpayers will perceive them to be inequitable to those who cannot afford to save. Finally, the revised system would still provide economic incentives (and, hence, disincentives) for certain investments and would require change as soon as promoting saving was no longer the primary goal.

The alternative of changing the current tax system has its own weaknesses, as do the others. However, it would probably not cause as large an economic disruption as those alternatives that suggest changing everything. Furthermore, as noted previously, other alternatives are inherently revolutionary and carry many administrative problems, as well as much uncertainty about their expected effects on saving and investment. In this sense, changing the current system is the alternative that gives relatively more certain predictions about effects on saving and investment, and the means that would encourage such activity most quickly.

Appendix A

Value-Added Tax Examples

Exhibit 1

Income-Tax-Base Calculation

Sales, net of returns and allowances		$1,000,000[1]
Cost of goods sold		
Beginning Inventory	$ 300,000 [2]	
Purchases	200,000 [1]	
Direct labor	400,000 [2]	
Supplies, etc.	100,000 [1]	
Total	1,000,000	
Ending Inventory	(400,000)[2]	600,000
Gross profit		400,000
Salaries	100,000 [2]	
Services, etc.	50,000 [1]	
Supplies, etc.	50,000 [1]	
Rent	40,000 [2]	
Depreciation	30,000 [2]	
Interest and taxes	20,000 [2]	
Other deductions	10,000 [2]	(300,000)
Net profit from operations		100,000
Royalties		50,000 [2]
Income tax base		$ 150,000
Income tax due at 46%		$ 69,000

[1]Accounts used in determining VAT liability under either the invoice or subtraction method.
[2]Accounts used in determining VAT liability under the addition method.

Exhibit 2

Reduced Rate at Wholesale Level

	(1) Purchases by Seller	(2) Value Added by Seller	(3) Sales Price (Column 1 plus 2)	(4) Cumulative VAT (Column 3 times VAT Rate)	(5) VAT Credit	(6) Payment to Government by Seller (Column 4 minus 5)
Manufacturer sells to wholesaler	—	$300	$300	$ 30[a]	(—)	$30
Wholesaler sells to retailer	$300	200	500	45[b]	($30)	15
Retailer sells to consumer	500	100	600	60[a]	(45)	15
Total Value-Added Tax Collection						$60

[a]Value-Added Rate at 10 percent.
[b]Reduced Value-Added Rate at 9 percent.

Exhibit 3

Reduced Rate at Retail Level

	(1) *Purchases by Seller*	(2) *Value Added by Seller*	(3) *Sales Price (Column 1 plus 2)*	(4) *Cumulative VAT (Column 3 times VAT Rate)*	(5) *VAT Credit*	(6) *Payment to Government by Seller (Column 4 minus 5)*
Manufacturer sells to wholesaler	—	$300	$300	$ 30[a]	(—)	$30
Wholesaler sells to retailer	$300	200	500	50[a]	($30)	20
Retailer sells to consumer	500	100	600	54[b]	(50)	4
					Total Value-Added Tax Collection	$54

[a]Value-Added Rate at 10 percent.
[b]Reduced Value-Added Rate at 9 percent.

Exhibit 4

Effects of an Exempt Sale at Wholesale and Retail Levels

	All Sales Taxable	*Exempt Wholesaler*	*Exempt Retailer*
Manufacturer sells to wholesaler			
Sales price	$100	$100	$100
VAT at 10%	10	10	10
Total cost	110	110	110
Wholesaler sells to retailer			
Total cost	110	110	110
Prepaid VAT	(10)	—	(10)
Value added	100	100	100
Sales price	200	210	200
VAT at 10%	20	—	20
Total cost	220	210	220
Retailer sells to consumer			
Total cost	220	210	220
Prepaid VAT	(20)	—	—
Value added	200	200	200
Sales price	400	410	420
VAT at 10%	40	41	—
Total cost	$440	$451	$420

Exhibit 5

Comparison of Export Sales (VAT Versus Non-VAT) Countries

	Exporter of the United States	*Exporter of a VAT Country*	
Selling price to customer in Morocco	$150.00	$150.00	
Manufacturing cost	100.00	100.00	
Insurance and freight	3.00	3.00	
Duty (10% ad valorem)	10.30	10.30	
Value-added tax paid out	—	10.00	
Tax eliminated on export	—	(10.00)	
Total expense	113.30	113.30	
Net profit before tax	36.70	36.70	
Income tax (at 46%)	16.88	14.68	(at 40%)
Net profit after tax	$ 19.82	$ 22.02	

Appendix B

Estimated Revenue From a National Sales Tax

Base: Source	Base: Type	Percentage of Personal Consumption	Estimated Revenue Yield Per 1% Tax ($ in billions): Fiscal Year 1983	Fiscal Year 1984	Fiscal Year 1988
McLure	Broad	79.1%	$16.7	$18.2	$24.7
	Narrow	45.4	9.6	10.5	14.2
Musgraves	Broad	75	15.8	17.3	23.4
	Narrow	35	7.4	8.1	10.9

Source: CRS computations are based on tax studies (McLure and the Musgraves) and aggregate personal consumption figures (Department of Commerce and DRI).

In estimating revenues that can be generated by a broad or narrow retail-sales-tax base, James Bickley in *National Sales Tax: Selected Policy Issues* used two different studies: one by Professor Charles E. McLure, and the other by Professors Richard and Peggy Musgrave. McLure used his own judgment in determining which items to exclude in order to establish a consumption tax base. His broad-based and narrow-based consumption taxes would be levied on 79.1 percent and 45.4 percent of personal consumption expenditures, respectively. The Musgraves used state-sales-tax exclusions in computing their base. Their broad base (encompassing 75 percent of consumer expenditures) excluded items "generally" excluded from state sales taxation; their narrow base (35 percent of consumer expenditures) excluded items "frequently" and "generally" excluded from state sales taxation.

Personal consumption expenditures for fiscal year 1983 were $2,112 billion; for fiscal year 1984, they were an estimated $2,304.7 billion. Thus, per 1-percent of tax, a retail sales tax derived from McLure's bases would have yielded $16.7 billion (1 percent × 79.1 percent × $2,112 billion) with a broad base, and $9.6 billion with a narrow base for fiscal year 1983. Similar estimates can be generated for fiscal year 1984 and for the Musgraves' data. If nothing else, the table demonstrates the larger revenue capacity of a retail sales tax.

Appendix C

Tax Expenditure Items — Effect on Savings

With the exception of the "Pro-savings" column, each attribute below was evaluated on a scale of 1 to 3, where 1 means the attribute exists to the least degree, and 3 means the attribute exists to the greatest degree.

The "Pro-savings" column uses a scale of −3 to +3: zero is neutral, negative numbers are anti-savings, and positive numbers are pro-savings.

(Note: See the third paragraph on page 42 about the subjective nature of much of this material.)

BUSINESS ITEMS	*Pro-savings* [a]	*Scope of Taxpayers Affected*	*Revenue Impact* [b]	*Adminis-trative and Statutory Simplicity*
Research and development deductions and credits	3	1	2	2
Industrial-development-bonds interest exclusion (see below for general-purpose bonds)	3	1	2	1
Accelerated depreciation	3	3	3	1
Investment tax credit	3	3	3	1
Reduced rates on first $100,000 of corporate income	3	3	2	3
Capital-gains lower rate (also included below)	3	3	2	3
Indexation (also included below)[c]	3	3	—	1
INDIVIDUAL AND EMPLOYEE BENEFIT ITEMS				
Itemized deductions				
Medical expenses	0	3	2	2
State and local taxes other than real estate credits	0	3	3	2
Real estate taxes	−3	3	3	3
Mortgage interest	−3	3	3	3
Consumer interest	−3	3	3	3
Charitable contributions	0	3	2–3	1
Deferrals and exclusions				
Deferral of gain on sale of residence	−2[e]	2–3	2	2
Exemption of $125,000 gain on sale of residence	1[e]	2	1	3
Exclusion of life-insurance-policy earnings	3	3	2	3
Medical care premiums paid by employer	−1	3	3	2
Social security benefits	0	3	3	3
Workmen's compensation benefits	0	2	2	2
Private-pension-plan contributions	3	3	3	1

	Pro-savings [a]	Scope of Taxpayers Affected	Revenue Impact [b]	Administrative and Statutory Simplicity
Group-term life insurance	3	3	2	3
Unemployment insurance benefits	0	2	2	3
Credits and other				
Capital gain-lower rate	3	3	3	1
Indexation of rates [d]	3	3	—	1
Investment tax credit	3	3	2	1
FMV-basis step-up at date of death	3	3	2	3
Child-care credit	0	2	1	2
IRA contribution	3	3	2	2
Second-working-spouse deduction	0	2	2	3
OTHER ITEMS				
Exclusion of interest — state and local general-purpose bonds	−3	3	3	2
Zero bracket amount [c]	0	3	2-3	3
Exemptions [c]	0	3	2-3	3

Notes:

[a]In the context used in this analysis, "Pro-savings" means the level of encouragement of individuals' investment in private sector *financial* assets and encouragement of business retention of income. "Pro-savings" as used here includes both increases in overall level of national saving and shifts within the components of national saving to more productive forms of investment.

[b]Revenue impact is based on the following figures.

Evaluation	Annual Tax Expenditure* (current year or projected future year)
1	$ 1–2 billion
2	2 + -10 billion
3	10 + billion

**Source: Tax Expenditures: Current Issues and Five-Year Budget Projections for Fiscal Years 1984-1988* (Washington, D.C.: CBO, October 1983).

[c]Not included in the official listings of tax expenditure items.

[d]Indexation of income tax rates for individuals started for tax years beginning in 1985.

[e]The exclusion of up to $125,000 of gain from the sale of a principal residence by taxpayers aged 55 years or older is believed to work in tandem with the tax-free rollover rules. Under current law, the exclusion is an incentive for the taxpayer to retain sales proceeds rather than reinvest in a more costly replacement home to gain the deferral benefit. The exclusion, therefore, encourages investment in more productive forms.

Notes

1. U.S. Treasury Department, *Blueprints for Basic Tax Reform* (Washington, D.C.: Government Printing Office, January 1977) and U.S. Treasury Department, *Treasury Report on Tax Simplification and Reform,* 3 volumes. (Washington, D.C.: Government Printing Office, 1984).
2. John B. Connally, "The Challenge for Tax Reform," in Charles E. Walker, *New Directions in Federal Tax Policy for the 1980s* (Cambridge: Ballinger Co., 1983), 5.
3. David G. Raboy, Testimony before the Subcommittee on Savings, Pensions, and Investment Policy and the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance. Washington, D.C., May 7, 1982, 1.
4. U.S. Treasury Department, *Blueprints,* 68–69; see also *Elimination of the Double Tax on Dividends,* AICPA Statement on Tax Policy No. 3 (New York: AICPA, 1967).
5. U.S. Treasury Department, *1984 Treasury Report,* 1:118–19.
6. Martin Feldstein, "Tax Reform and Capital Formation," Address to the American Council for Capital Formation. Washington, D.C., January 19, 1983, 1, 4.
7. William E. Simon, *Reforming the Income Tax System* (Washington, D.C.: American Enterprise Institute, 1981), 8.
8. Under Kemp-Kasten all income would be taxed at a flat 25 percent rate. However, 20 percent of employment income under the social security wage base would be excluded from tax. For taxpayers with employment income above the social security base, the excluded income is added back at a 12.5 percent rate as income rises.
9. Robert E. Hall, and Alvin Rabushka, *Low Tax, Simple Tax, Flat Tax* (New York: McGraw-Hill, 1983), 93.
10. Richard Goode, "The Comprehensive Income Tax: Advantages and Disadvantages," in Walker, *New Directions in Federal Tax Policy,* 270–73.
11. Arnold C. Harberger, "The State of the Corporation Income Tax," Address to the American Council for Capital Formation, Washington, D.C., January 20, 1983, 1.
12. This problem of imputing values is discussed in *Blueprints,* 85.
13. U.S. Treasury Department, *1984 Treasury Report,* 1:25.
14. Joseph J. Minarik, Testimony before the Subcommittee on Monetary and Fiscal Policy, Joint Economic Committee, Washington, D.C., July 27, 1985, 15.
15. Ibid., 2.
16. Ibid., 2–3.
17. Simon, *Reforming the Tax System,* 35.
18. Minarik, Testimony, 3.
19. Goode, "Comprehensive Taxation," 270.
20. This is discussed in depth in Minarik, Testimony, 4.
21. Ibid.
22. U.S. Treasury Department, *1984 Treasury Report,* 1:16.
23. Ibid., 1:4.
24. See, for example, Goode, "Comprehensive Taxation," 270.
25. U.S. Treasury Department, *1984 Treasury Report,* 1:14.
26. Ibid., 1:15.
27. John Zimmerman, "The Flat Tax: A Closer Look," *The CPA Journal* (February 1984): 31–35.
28. U.S. Treasury Department, *1984 Treasury Report,* 1:14.
29. Donald Kiefer, *Tax Revision: An Economic Overview* (Washington, D.C.: Congressional Research Service, October 1984), 4.
30. U.S. Treasury Department, *1984 Treasury Report,* 1:22.

31. Kiefer, *Tax Revision,* 4.
32. U.S. Treasury Department, *Blueprints,* 23.
33. This section on capital formation draws heavily from the discussion in Pamela B. Gann, "Taxation of Capital Income under Three Tax Reform Plans," *Tax Notes* (January 14, 1985): 187–92.
34. Ibid., 188.
35. Ibid.
36. Congressional Budget Office, *Revising the Individual Income Tax* (Washington, D.C.: CBO, 1983), 51.
37. Goode, "Comprehensive Income Tax," 14.
38. Minarik, Testimony, 12–13.
39. U.S. Treasury Department, *1984 Treasury Report,* 1:23.
40. Minarik, Testimony, 13 (quoting a Harris poll).
41. Congressional Budget Office, *Revising the Tax,* 30–36.
42. Thomas Hobbes, *Leviathan; or, The matter, forme and power of a commonwealth, ecclesiasticall and civil.* (London: 1651).
43. U.S. Treasury Department, *Blueprints,* 11.
44. Ibid., 123–24.
45. Ibid., 123.
46. Michael A. Schuyler, *Consumption Taxes: Promises & Problems* (Washington, D.C.: Institute for Research on the Economics of Taxation, 1984), 59.
47. U.S. Treasury Department, *1984 Treasury Report,* 1:193.
48. Ibid.
49. Schuyler, *Consumption Taxes,* 60.
50. U.S. Treasury Department, *Blueprints,* 131–32.
51. Ibid., 116–17.
52. Ibid., 133–34.
53. For an in-depth discussion, see Henry J. Aaron and Harvey Galper, "A Tax on Consumption, Bequests, and Gifts and Other Strategies for Reform," in Joseph A. Pechman, ed., *Options for Tax Reform* (Washington, D.C.: The Brookings Institution, 1984), 133–34.
54. David F. Bradford, Testimony before the Subcommittee on Monetary and Fiscal Policy, Joint Economic Committee, Washington, D.C., August 19, 1982.
55. Simon, *Reforming the Tax System,* 39–40.
56. Feldstein, "Tax Reform," 20.
57. Jack Carlson, "Proposals to Reform the Federal Tax System," Statement on behalf of the National Association of Realtors, before the Senate Finance Committee, Washington, D.C., August 7, 1984, 22.
58. Tax Foundation, "Consumption Tax: An Idea Whose Time Is Coming," Tax Foundation, Inc., Washington, D.C. (September 1983), 1.
59. U.S. Treasury Department, *1984 Treasury Report,* 1:205.
60. Ibid., 1:199.
61. Gregg A. Essenwein, *Taxing Consumed Income: An Overview and Theoretical Analysis* (Washington, D.C.: Congressional Research Service, June 12, 1984), 20.
62. U.S. Treasury Department, *Blueprints,* 21–52.
63. Joseph A. Pechman, "Tax Policies for the 1980s," *Tax Notes* (December 22, 1980): 1198.
64. Michael J. Boskin, "Tax Policy, Saving, and Economic Growth," Address to the American Council for Capital Formation, Washington, D.C., January 19, 1983, 19.
65. Congressional Budget Office, "Revising the Individual Income Tax," 21.
66. Charles E. McLure, Jr., "Value-Added Tax: Has the Time Come?," in Walker, *New Directions in Federal Tax Policy,* 187.
67. For discussion of this area in general, see AICPA Statement on Tax Policy No. 2, *Value-Added Tax* (1975).
68. U.S. Treasury Department, *1984 Treasury Report,* 3:40.
69. Ibid., 3:5–7.
70. Ibid., 3:32.
71. Ibid., 3:85–87.
72. For an excellent discussion of the economic effects of a VAT, see Norman B. Ture, *The Value-Added Tax: Facts and Fancies* (Washington, D.C.: The Heritage Foundation, 1979), 49–54.

73. McLure, "Value-Added Tax," 196.
74. Ibid.
75. See AICPA Federal Taxation Division, *Underreported Taxable Income: The Problem and Possible Solutions,* (Washington: AICPA, 1983).
76. *Budget of the United States Government, Fiscal Year 1986,* Historical Tables, Table 2.1 (Washington, D.C.: Office of Management and Budget, 1985).
77. For a discussion of the revenue potential of a VAT, see Ture, *The Value Added Tax,* 54–67.
78. See Pechman, "Tax Policies," 1198.
79. U.S. Treasury Department, *1984 Treasury Report,* 3:21.
80. See also Eric Schiff, *Value Added Taxation in Europe* (Washington, D.C.: American Enterprise Institute, 1972), 21–42.
81. U.S. Treasury Department, *1984 Treasury Report,* 3:113.
82. Ibid., 3:26–27.
83. Ibid., 3:27.
84. Ibid.
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M061042